Pettinga Insights and Outlook

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Options to Invest Cash

Investors with cash holdings want to invest them in something safe that will earn at least a little interest. Money markets and short-term bond funds are good places to start. Money markets come in two flavors: money-market accounts offered by banks and money-market funds offered by mutual fund companies. Bank money-market accounts are typically protected by the Federal Deposit Insurance Corporation, or FDIC, while money-market funds are not.

For a combination of safety and yield, an FDIC-insured online bank money-market account may be a good option, at least for now. That could change if and when interest rates rise, if such an increase would allow short-term bond funds to begin paying yields that are significantly higher than money-market yields. But given today's choice between a guaranteed rate of close to 1% and a nonguaranteed rate that's not much higher, the former appears to be a better option.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money. An investment in a money-market fund is not insured or guaranteed by the FDIC or any other government agency. Although money-market funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in them. Bonds are subject to interest-rate risk. As the prevailing level of bond interest rates rise, the value of bonds already held in a portfolio declines. Portfolios that hold bonds are subject to fluctuations in value due to changes in interest rates.

The Many Faces of Risk, Part 1

There is no question that risk carries a negative connotation for investors. But the simple fact about risk is that it’s ever-present. There is more to risk than market volatility, and trying to avoid risk is like trying to avoid the oxygen in the room. You might think you're avoiding it by sticking with safer investments, such as bonds. But when you make moves like this, you're usually just swapping one kind of risk for another. In this case, you may have reduced short-term volatility risk, but you likely increased long-term shortfall risk: With a heavy emphasis on lower-yielding "safe" investments, your portfolio may not grow enough to meet your retirement needs or overcome inflation over the long term.

On the flip side, we may also mistake an upward trend in the market for the absence of risk. A strong performance streak doesn't mean there was no risk. It just means that risk didn't bite hard during that time period. Don't confuse being lucky with being risk-proof.

So, we can't avoid risk. But neither should we be oblivious to it. What we need to do is understand the risks we're taking, and remember risk's traveling companion: reward. This keys in on an important point: Risk isn't inherently bad. When you take risk, you can have good outcomes, too. Risks should have related and commensurate potential rewards. We invest in the market not because risk is bad and we expect to lose money, but because taking risk can be profitable. So, the question is not whether to take risk. Instead, it's what risks do you want to take, and how much?

Types of Risk

As suggested above, there is more than one kind of risk, and to manage risk well, you need to consider the different types. For instance, investing risk is not all (or even mostly) about the market's volatility (the Dow's daily ups and downs on Fed talk, China's latest data, or any number of global worries).

When thinking about investment risk, you need to consider company fundamentals (what will cause this firm to succeed or fail), because that will ultimately drive the stock price over time. There is also price risk. Even if the company is poised for tremendous success, how much are you paying to own a piece of it? If you overpay, you can still lose money, because stocks tend to revert to their fair value over time, even if they occasionally become under- or overvalued.

You also have to consider your own shortfall risk. Conceivably, you're investing in the market to fund some future expense (for instance, college or retirement). If you take money out of the market, or move money from stocks to bonds, what does that mean for your long-term earning potential, given the types of returns bonds tend to produce over long periods of time? Remember, funding that future expense is your primary objective, not avoiding every little dip in the market along the way.

But instead of fundamental, price, and shortfall risk, we investors tend to focus on short-term volatility because that's the thing we see every day, in real time. It's the most apparent and seemingly uncontrollable risk. Make no mistake, volatility may reflect real changes in a company's fundamentals, and that can mean a real loss of money for you. But volatility is often just noise, reflecting worries that won't have any lasting or appreciable effect on a company's operations. In these cases, we shouldn't let volatility risk leave the realm of paper losses.

That's easier said than done, of course, especially during a market crisis or correction. But one way of getting around that is by considering another type of risk: liquidity risk. That's the risk that you can't sell an asset (or at least can't sell it for a reasonable price) when you need to sell it. The upshot: If you have a short-term need for cash, then have cash on hand. That allows you to ride through the volatility risk of your other assets.

Monthly Market Commentary

In recent economic data, payroll numbers correct sharply, manufacturing continues to slow down fueled by the strong dollar and low oil prices, and the pace of home price growth increases as inventory levels remain low.

Employment: The U.S. economy added a disappointing 126,000 jobs in March. Certainly the over 300,000 jobs added late last year looked downright out of place. Job growth accelerated in a period when economic growth was slowing. Now with the much slower reported job growth in March and the substantial revisions to prior months, the employment data looks much more in line. However, the 126,000 jobs added in March is not the new normal, it was just an adjustment month.

The strong job openings data (from the end of February versus the jobs report, which is from the second week of March) confirms that the job market is not falling apart. In fact, the huge number of openings suggests that employers will need to pay more or be more willing to train workers before the pace of hiring will increase. Besides the job openings report, other metrics that point to a benign if not robust jobs market include initial unemployment claims, the labor sections of the small-business sentiment report, and various purchasing manager reports, as well as the ADP report.

Manufacturing: The ISM purchasing manager report continued to show a slowing—not panicky—manufacturing sector. The pace of deceleration has continued unabated since October and peaked way back in August. That weakness is now clearly visible in the month-to-month industrial production data that is now down three months in a row. The year-over-year data is at its early stages of deterioration, with more bad news likely with the softer March ISM report this week and a weak durable goods report last week.

The weakness in the ISM data was rather broad-based with just current production levels and prices paid subcomponents showing increases. Employment data was particularly weak, with that index dropping to 51.4, marking a second straight month of sharp declines. ADP payroll data suggested that March manufacturing employment was basically unchanged from February. Order backlogs also dropped sharply in March, although that may be because the port strike settlement in late February enabled manufacturers to clear backlogs. In some more clearly bad news, export orders remained well below the 50 level that separates growth from contraction, falling from 48.5 in February to 47.5 in March. It will probably take either a pop in auto manufacturing or a restart of the housing industry to get the manufacturing data humming again. That's a real possibility by late summer, but probably not enough to help in the next month or two.

Housing: Recent pricing data suggests that home prices are on the rise again. According to CoreLogic, home prices increased 1.1% between January and February and were up 5.6% February over February. Year-over-year prices have been up for 36 consecutive months, or three years. The rate of home price growth has been slowing since fall 2013 when growth was as high as 11.9% compared with the current single-month reading of 5.6%. Still, it appears that the decline in the rate of home price appreciation has been stopped, with prices moving back up since a low reading of 4.7% in December. The three-month averaged, year-over-year data shows a similar pattern. We have also included CoreLogic-estimated results for March in the table below. We had estimated home price growth in 2015 at 4%–6%. Recent inventory data and price trends suggest that the high end of this range is now more likely.

Auto sales: On a more positive note, auto sales for March showed 17.1 million units sold (on a seasonally adjusted annual run-rate basis), the highest March number going back to 2000. Auto sales are one of the best indicators of consumer confidence, so this may be a sign that consumers are emerging from their malaise and could show some strength as we move into the spring.

Retirement Distribution Pitfalls: Variability in Withdrawals

Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be not allowing for some variability in your withdrawals, based on need. Many retirees use the 4% rule, which holds that you withdraw a specific dollar amount in year 1 of retirement, then adjust that dollar amount upward each year to account for inflation. Even though this rule can provide a good starting point, it's unrealistic to expect that you'll stick with a fixed withdrawal amount every year. You may have years when you need to spend more, such as for a new car, new roof, child's wedding, or a special vacation, and years when you can get by with less.

Workaround: Be sure to pad anticipated expenses a bit to account for extras and unanticipated expenditures. Some retirees, for example, forecast when they would need to replace cars, take big trips, and repair roofs. Those padded expenses should be used when determining whether a withdrawal rate is sustainable. Alternatively, retirees could manage their distributions with the expectations that they will in fact not be static from year to year—for example, paying for unanticipated expenses on an as-needed basis with the expectation that they'll have to tighten their belt in subsequent years.

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