Pettinga Insights and Outlook

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Risk, Not Volatility, Is the Real Enemy

What would you do if your investments lost 10% in a single day? A) Add more money to my account. B) Hold steady with what I've got. C) Yank my money; I wouldn't be able to stand any more losses.

If investors buy the right investments but sell them at the wrong time because they can't handle the price fluctuations, they may have been better off avoiding those investments in the first place. Most investors are poor judges of their own risk tolerance, feeling more risk-resilient in up markets and more risk-averse after market losses. However, focusing on an investor's response to short-term losses inappropriately confuses risk and volatility. Understanding the difference between the two and focusing on the former is a potential way to make sure you reach your financial goals.

Volatility encompasses the changes in the price of a security, a portfolio, or a market segment, both on the upside and downside, during a short time period like a day, a month, or a year. Risk, by contrast, is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. So how can investors focus on risk while putting volatility in its place? The first step is to know that volatility is inevitable, and if you have a long enough time horizon, you may be able to harness it for your own benefit. Diversifying your portfolio among different asset classes can also help mute the volatility. It helps to articulate your real risks: your financial goals and the possibility of falling short of them. Finally, plan to keep money you need for near-term expenses out of the volatility mix altogether.

Investing in securities always involves risk of loss. Diversification does not eliminate the risk of experiencing investment losses.

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We offer a no-obligation introductory meeting to interested persons and institutions to determine if we can add value to their individual situation.

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Monthly Market Commentary

The worst of the fiscal cliff crisis was averted as Congress managed to come to a deal at the eleventh hour. As part of the deal, tax rates will go up for high-income earners, and the payroll tax holiday will expire, affecting income earners across the board. The new tax rates may slow the economy, but also decrease some of the uncertainty. Markets reacted positively, with the S&P 500 jumping more than 4% in the first week of January.

GDP: The third and final estimate for third quarter real GDP growth was revised sharply higher to 3.1%, from an initial estimate of 2.0% and also higher compared with the second quarter real GDP growth rate of 1.3%. This makes it the third-best quarter of the 13-quarter recovery. Consumption and import/export figures were revised upwards, while inventories were less of a contributor than previous estimates.

Employment: In December, 155,000 jobs were added, mainly from strong growth in the health-care and construction sectors. More importantly, hours worked and hourly wage rates were also up. Taking into consideration average hours, average wages, and employment, Morningstar economists believe that total private wages grew at a stunning 0.7% in December (8.4% annualized). Given that there was limited inflation in December, these gains may flow almost immediately to consumers. Going into January, with higher taxes, this large income growth will provide consumers with a substantial cushion. The unemployment rate in December inched up slightly to 7.8%.

Housing: Original housing market forecasts for 2012 ranged from more doom and gloom to minuscule improvements. Instead, the U.S. got a year of considerable advancement, with home inventories down significantly, which has led to higher prices across the board. With inventories so low, it is now difficult to buy a home in many markets, especially on the West Coast. Home builders are also constrained by raw material prices going up, as well as a shortage of construction workers. Morningstar economists believe that home price gains of 5% or more for all of 2012 are pretty much certain, but volume-related housing metrics will slow in 2013 given these supply constraints.

Auto: Auto sales in December were at about 15.4 million units, down slightly from the 15.6 million units sold in November, which benefited from required replacements associated with Hurricane Sandy. The auto industry has been a real plus for the U.S. economy. The durable goods sales category (mainly comprised of autos), has been the single largest contributor to the economic recovery so far. While much of Europe is struggling with declining auto sales, the U.S. managed to pull out another year of very impressive growth.

Retail: Holiday sales (essentially November and December) were up 3.1% from a year ago. Sales in December showed a sharp improvement compared with November, which reflected the impact of accounting for layaway sales, Hurricane Sandy, and the timing of Cyber Monday this year. Overall, the holiday season was good, but not great. Consumer headwinds were substantial, ranging from Hurricane Sandy at the beginning of the season to worries about the fiscal cliff at the end of it. Thankfully, improved consumer incomes, falling gasoline prices, cooler temperatures, and more discounting at the end of the season, all helped boost sales.

Year-end insights: Despite odd weather patterns, presidential election jitters, and fiscal cliff concerns, 2012 was filled with much positive news for the U.S. economy. This included higher oil production, an improved auto industry, decreased commodity prices, and a stabilizing housing market. Unfortunately, the same could not be said about Europe, which entered a recession, or China, whose growth slowed dramatically. The relative strength of the U.S. economy also translated into benefits for consumers, who experienced steady employment growth, stable inflation, rising financial assets, and a nicely improving real estate market.

Economic Outlook for 2013

2012 has been far from uneventful: election year in the U.S., ongoing sovereign debt crisis in Europe, potential real estate bubble in China, food and energy prices on the rise and, of course, the fiscal cliff and looming uncertainty ahead for American taxpayers. Fortunately, though, there may be some good things in store for 2013.

U.S. GDP Expected to Grow by about 2% in 2013: Morningstar economists estimate that GDP growth is likely to drop from very close to 3% in the third quarter to a slower 1%–2% in the fourth (mainly because of Hurricane Sandy's devastating effects). The true strength of the U.S. economy is probably an average of these two extremes, or about 2%.

Slower Growth May Keep Inflation in Check and Indicate a Longer, More Durable Recovery: The recovery is now approaching 3.5 years in length, testing consumers' patience but also preventing inflation from rising too fast. Morningstar economists project an overall inflation rate of about 2% for next year. Slow worldwide economic growth and more controlled commodity demand from emerging markets would point to more stable food and energy prices in 2013, potentially driving overall inflation as low as 1.5%. However, food and energy prices are among the most difficult to forecast, and because of them the overall inflation estimate may not be as certain as other projections.

Consumer Spending Stable to Modestly Higher in 2013: The consumer represents about 70% of U.S. economic activity and, as long as inflation remains under about 4%, may continue to power the economy ahead. Good news for the consumer in 2012 included slow but steady employment growth, stable inflation, rising financial assets, and a nicely improving real estate market. Now that a fiscal cliff decision has been reached, Social Security taxes will increase by 2% in 2013 at all income levels, and high-earning individuals (above $400,000) and couples (above $450,000) will face higher taxes on income above these thresholds. For this reason, lower-income and especially middle-income earners may do better than high-income earners in 2013.

Housing, a Big Change Factor in 2013: The recovery growth drivers are likely to change again next year. Although housing clearly began to turn in 2012, the effects were relatively muted. While direct housing investment will be a meaningful contributor in 2013, some of the ancillary goods and services that are housing-related will also finally kick in (for example, mortgage brokers, furniture sales, and remodeling businesses that may take longer to recover than housing itself).

1.8% Employment Growth Possible; Unemployment Rate May Drop to 7.1%: Year-over-year employment averages have been relatively consistent at 1.8% growth for some time. At this rate, all the jobs lost in recession may not be recaptured until sometime toward the end of 2014. However, employment growth of 1.8% can easily support GDP growth in excess of 2% due to higher productivity levels. The net labor market is expected to increase by about 1 million in 2013 (compared with about 1.3 million in 2012), which translates into a drop in the unemployment rate from an estimated 7.8% in 2012 to 7.1% by the end of 2013.

The U.S. Economy Not Drastically Affected by World Economic Slowdown: U.S. economic growth in 2012 was very close to the level experienced in 2011. The U.S. benefited from higher oil production, an improved auto industry, decreased commodity prices, and a turn in the housing market, avenues of growth that were not available in a lot of other countries. At the same time, Europe moved into a recession, and growth in China and other developing markets slowed dramatically (though in many cases, growth rates were at a higher level than in the U.S. before the slowdown). As emerging markets now begin to show signs of stabilization, there may be more room for earnings improvement in 2013. However, Europe could still be problematic, as its fiscal issues remain far from solved.

Money Market Fund Basics

When you invest for the long haul, whether to fund retirement or your child's college education, you should also keep a cash reserve to meet short-term demands and handle emergencies. In addition to your basic savings or checking accounts, money market mutual funds can be a great place to park that cash reserve. Money market funds invest in short-term, high-quality debt, and are among the most conservative funds available. They invest in bonds issued by extremely stable debtors, such as the U.S. government, and large, financially sound companies.

Money market funds typically pay a percentage point more than money market accounts from banks. You'd get even less interest if you put your cash in a checking or savings account. Keep in mind, though, that unlike consumer bank accounts, money market funds are not insured by the Federal Deposit Insurance Corporation (FDIC). However, they are regulated by the United States Securities and Exchange Commission (SEC), which enforces strict limits on the types of investments these funds can make. Consequently, it is unusual for a fund to take a hit to its principal, but, like with any other investment vehicle, it is still possible to lose money. When choosing a money market fund, be sure to bargain hunt: Low-expense funds have an edge that's hard to beat. Also, be sure to find a package that works for you. In general, money market funds have low minimum investment requirements and may offer limited check-writing privileges, but these characteristics vary widely from fund to fund.

Investors should read the prospectus and carefully consider a fund's investment objectives, risks, fees, and expenses before investing. Money market funds are portfolios that invest in short-term money market securities in order to provide a level of current income that is consistent with the preservation of capital.

Pettinga
Get there.

Pettinga Financial Advisors
519 Main Street
Suite 100
Evansville, Indiana 47708