Pettinga Insights and Outlook

July 2013 | Vol. No. 1 | Investment Updates

Know Your Risks

Risk 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. Investors face many forms of risk depending on the kinds of investments they choose.

Market, industry, and company risk: General market fluctuations can affect securities trading in that market. Stocks tend to fluctuate more than other asset classes, and may pose more risk over short periods of time. Investors looking to time the market run the risk of jumping into the market during the worst times, and out of the market during the best times. Security values can also decline from negative developments within an industry or company.

Credit and interest-rate risk: Credit risk is the possibility of a bond issuer not being able to make timely payments of principal and interest. The value of a bond may also decrease due to financial difficulties or the declining creditworthiness of the issuer. Interest -rate risk relates to how bonds tend to rise in value when interest rates fall, and to fall in value when interest rates rise. Typically, bonds with longer maturity exhibit greater price volatility.

Inflation risk: Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past.

Liquidity risk: Some investments may not be widely held by the public and may be difficult to sell if prices drop dramatically.

Currency risk: Returns achieved by local investors are often different from returns achieved by U.S. investors because of foreign exchange rates, even though both are investing in the same security.

Monthly Market Commentary

The markets went through a lot of turmoil in June, as stronger economic reports were offset by fears of the Fed tapering its bond-buying programs. Home prices, employment reports, and auto sales were all better than expected, unlike trade and GDP data. Together with falling business investment and government employment, that leaves the consumer and housing as the two main engines of economic growth.

Federal Reserve news: Fed statements and a news conference suggested that the economy was stronger than it previously thought, and, as a direct result, bond purchases could be cut back as early as this year and eliminated as early as the middle of 2014, if the economy tracks Fed forecasts and the unemployment rate is around 7%. This, combined with a solid employment report, caused a significant increase in mortgage rates the Friday after Independence Day. For example, 30-year fixed rates climbed into 4.75% territory, with some lenders at 4.875% (according to Mortgage News Daily).

GDP: The third and final revision of first-quarter GDP growth revealed a lower-than-expected 1.8%. The Fed's outlook for the economy has been remarkably bullish, with forecasted GDP growth for 2013 of 2.3%–2.5%—a little too high, in light of the weak first quarter.

Employment: The June employment report showed growth of 195,000 jobs, similar to the previous three months when all revisions are considered. This number was better than the 12-month average and the consensus estimate of about 160,000 jobs. Year-over-year three-month average data has remained virtually stagnant in the 1.9%–2.1% range for almost a year (2.0% for June). However, the mix of jobs added wasn't great. The leading categories were leisure/entertainment and retail; manufacturing and government were down. In other words, jobs considered to be higher-quality and better-paying were down, while lower-paying jobs showed most of the growth. Also, health care and education, normally strong sectors, showed about half of their normal growth. The unemployment rate remained unchanged at 7.6%.

Housing: Reported CoreLogic data for May showed that prices increased 12.2% compared with May a year ago, the biggest percentage increase since 2006. This also marks the 15th consecutive monthly increase in prices. These price increases (along with falling gasoline prices) may be behind the jumps in consumer confidence and consumer spending that exceeds income gains. Even higher mortgage rates are not likely to quell recent price movement by much. In fact, attempts to beat the mortgage-rate increases may be driving some of the real estate activity.

Consumer spending: The personal consumption report showed that spending was locked in its same tight range, with income growth improving but trailing way behind spending growth. Regrettably, income growth is likely to keep a lid on consumption growth, which in turn will keep GDP in check.

Trade: The U.S. trade deficit jumped from $40.1 billion in April to $45.0 billion in May. Exports shrunk by about 0.3%, as expected, but imports grew by 1.9%, indicating that the U.S. economy is stronger and improving compared with most of its trading partners. Global Purchasing Managers Index (PMI) data for the manufacturing sector was strongest for the U.S., with Europe second and China the weakest. This is probably not great news for those expecting China and other emerging markets to drive the world economy.

Quarter-end insights: Overall, it still looks like the economy is on the road to continued (if moderate) 2% growth, inflation is likely to remain below 2%, and long-term interest and mortgage rates are destined to go higher. When, not if, is the correct question to ask relative to interest rates. A tougher Fed and a tightening U.S. federal fiscal policy may keep a lid on short-term economic activity, but long-term fundamentals look strong.

Don't Let Small Numbers Distract You From the Big Picture

Even though it's all about dollars and cents, the financial industry runs on percentages; dollar signs are few and far between. The use of percentages is an understandable, and helpful, convention when communicating financial information. After all, a headline saying “Company A’s Net Jumps by 16%" is more helpful than one that reads "Company A’s Net Jumps to $1.02 billion.” Providing percentages rather than dollars also allows investors to compare apples to apples: You can readily discern that an investment that has gained 8% during the past 10 years has been a better bet than one that has gained half as much.

Yet dealing in percentages, especially relatively small ones like inflation rates, expense ratios, and long-term annualized returns, can also distract from important information that factors into your financial plan. Those small and innocuous-looking percentage figures, when translated into dollar terms and compounded over many years, can make a huge difference between success and failure.

How Small Numbers Can Make Your Investment Plan…: Say, for example, that you stick with the 3% 401(k) contribution rate that your company uses as the default, contributing $1,500 of your $50,000 salary for 40 years and earning 5% on your money. You'd have about $190,000 at the end of the period; not too shabby. But bumping up your percentage contribution just 2 percentage points (to 5%) would have a meaningful impact on your bottom line, increasing your nest egg to nearly $320,000.

In a similar vein, you might choose to keep your child's college fund in cash. Assuming cash yields stay as low as they are now (which is, admittedly, a big assumption), a $50,000 investment that earns just 1% for the next 10 years will amount to just $55,000 at the end of the period. But by maintaining a 60% stock/40% bond portfolio and assuming a not unreasonable 4% return, you'd be able to grow your $50,000 investment to $74,000. Neither return rate will allow you to keep up with college inflation, sadly, but at least it's better than putting the money under your mattress. However, keep in mind that the 60/40 portfolio entails market risk.

…or Break It: Just as seemingly small percentage changes (either in contributions or return rates) can provide investors with an enormous helping hand, they can also work in reverse, and this is where many investors run into trouble. They blow off small percentage amounts like expense ratios and inflation rates when making investment decisions.

For example, let’s say an index fund has a fairly low expense ratio of just 0.63%. It's certainly cheaper than most actively managed funds, and it doesn't appear to be that much more expensive than most other S&P 500 index funds, some of which charge as little as 0.06%. If you opted for the expensive fund rather than a cheaper alternative and you held it for a long time, you'd be shortchanging yourself. Assuming a 10% annualized return and a $100,000 initial investment, you'd be leaving a lot of money on the table during a 25-year period by opting for the more expensive fund: nearly $170,000, to be exact. All because your fund charged 0.57% per year more than a comparable option.

Inflation is another factor that investors tend to underestimate, because the average historical inflation rate of roughly 3% looks pretty benign when viewed without any context. Should the fact that bananas that are $0.59 a pound today but might be $0.79 a pound 10 years from now cause a major rethinking of your financial plan? Yes, actually. When you extrapolate inflation across all of the items in your shopping cart and compound it over many years, it can have a hugely corrosive effect on the purchasing power of your savings, meaning you need to save a lot more than you thought you did.

The Fake Tweet Mini-Crash

On April 23rd, 2013, the Associated Press' (AP) Twitter account was hacked, sending a message that the president was injured in an explosion at the White House. This fake tweet resulted in a rapid decline of roughly 1% in the financial markets, fueling speculation that high-frequency trading was the main culprit. Although the market recovered quickly following the hoax, it reminded investors of the flash crash from May 2010 or Knight Capital Group's computer glitch in 2012. In the end, this mini-crash had little to no effect on the long-term investor. While a mini-crash like this raises questions about repeat occurrences in the future, making it hard for investors to overlook, ignoring short-term price fluctuations and focusing on the value of investments may be the best policy for long-term investors.

Examples of Crashes

Name	Date	Cause & Consequences
Fake Tweet Mini-Crash	April 23, 2013	Fake tweet sent by AP's hacked Twitter account, announcing explosion at White House. Markets fell, but recovered almost immediately.
Knight Capital Group	August 1, 2012	Technology issues led the company to accidentally buy and sell millions of shares, causing significant price disruptions to 140 stocks listed on NYSE.
BATS Global Markets	March 23, 2012	Software glitch with disastrous consequences affected stocks with tickers from A to BF, including the company's own stock on the very day of its (failed) IPO.
The Flash Crash	May 6, 2010	Sudden (and difficult to explain) lack of liquidity in the markets caused 8,000 securities to decline and recover in a matter of minutes. Circuit breakers (limits that automatically halt trading) were implemented as a result.

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