Pettinga Insights and Outlook

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Understanding Risk Tolerance and Risk Capacity

When determining an appropriate asset allocation mix, it is important to consider not only one's risk tolerance, but also one's risk capacity.

An investor's risk tolerance refers to his or her aversion to risk, while an investor's risk capacity relates to his or her ability to assume risk. Sometimes, an investor's risk capacity and risk tolerance do not match up. If an investor's capacity to take risk is low but the risk tolerance is high, then the portfolio should be reallocated more conservatively to prevent taking unnecessary risk. On the other hand, if an investor's risk capacity is high but the risk tolerance is low, reallocating the portfolio more aggressively may be necessary to meet future return goals. In either case, speaking with a financial advisor may help to determine if your risk tolerance and risk capacity are in sync.

Risk Strategy Matrix

		Risk Capacity	
		High	**Low**
Risk Tolerance	**High**	No action required	Consider reallocating more conservatively
	Low	Consider reallocating more aggressively	No action required

There is no guarantee that diversification or asset allocation will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. It is highly recommended that you consult with a financial professional for advice specific to your situation.

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Monthly Market Commentary

As May saw spring slowly roll into summer, bond markets were sent into a tailspin by strong consumer confidence reports and real estate price data. Stocks managed to do better than bonds, but were still a little off as Germany and the rest of Europe decided to ease up on some of their austerity measures.

Employment: The U.S. economy added 175,000 jobs in May, just a little better than 149,000 in April, and the consensus forecast of 169,000. That's not far off the average for the previous 12 months, which is 179,000 jobs. Year-over-year average data has shown steady growth of around 1.9%–2.0% for almost two years, which is consistent with GDP growth of 2.1%–2.3%. Equity markets reacted positively to the employment numbers, but commodity and bond markets were not as thrilled. The jobs report was high enough to convince investors that the next recession wasn't around the corner, and just weak enough that Fed bond-buying programs are not likely to be eliminated in the very near future. The unemployment rate climbed to 7.6% in May from 7.5% in April.

Housing: Pending home sales showed a modest uptick in April, which should bode well for existing home sales in the months ahead. The Case-Shiller Home Price Index posted a 10.5% increase for April (calculated in year-over-year, 3-month average terms), indicating that the 6%–8% price appreciation seen in 2012 could be followed by a potential 8%–10% move in 2013. However, the Case-Shiller 20 is still about 28% below its all-time high, affordability remains near record-high levels, and not every geographic market is participating uniformly in the large increases. Also, low inventories and still-tight lending conditions are two major factors currently holding back the housing market.

Consumer Spending: The most important thing to remember when measuring this type of economic indicator is that month-to-month numbers fluctuate a lot and are not nearly as significant as long-term trends. Year-over-year data has been exceptionally stable and telling a story of slow and steady improvement. However, there is a sizable gap between income and spending. Spending itself remains stuck in the same 2% annual growth trajectory it has been on for more than two years. Meanwhile, income growth remains considerably below that level, which suggests that even if the consumer is optimistic, the fuel necessary for more spending is running a little low. Consumers in the top income quartile (who are big savers) really need to step it up spending-wise, and weather and gas prices need to cooperate to keep the U.S. economy from settling back a little in the second quarter and in the second half of 2013.

Trade: The U.S. trade deficit as a percentage of GDP has continued to shrink from 5.7% in 2005 to 2.9% in 2012 and 2.85% in the first quarter of 2013. The deficit has remained steady the last several years, even as the U.S. economy has entered a recovery (the trade deficit generally increases in a recovery and decreases in a recession). Continuing good news on the U.S. oil and gas front could improve the deficit even further. A smaller trade deficit points to a smaller need to borrow money from outside the U.S. and also generally means a stronger currency, which in turn helps control inflation.

Overall, Morningstar economists believe that 2013 may still turn out OK, with 2.0%–2.25% GDP growth, inflation well below 2%, and employment growth of about 1.8%. Real estate and consumer spending (especially on housing-related items) remain the bedrock to forecasts for the rest of the year. Government, business spending on structures and technology, and exports are likely to provide a headwind for most of 2013. The Affordable Care Act could be either a headwind or a tailwind. To get GDP growth much in excess of 2% now will require a few lucky breaks in weather, inflation, and Europe. All possible, but it's hard to take that to the bank. In fact, just a couple of bad breaks and the Fed's next move might be more loosening, not tightening.

What Is a Bond Ladder?

Laddering a bond portfolio means that you buy bonds with varying maturity dates, for example: one bond maturing in a year, another in three years, and two others maturing five and 10 years from now, respectively. When the bonds mature, the investor can either spend the proceeds, which would necessitate matching the maturity dates of the bonds in the ladder to spending needs (for example, when college tuition comes due each year) or reinvest in another bond that matures at a later date.

Laddering is, above all, a diversification strategy, enabling you to spread your assets across multiple credits with different characteristics, thereby mitigating the risk of sinking a lot of your assets into a single bond that defaults. And if you're reinvesting your proceeds when a bond matures, laddering helps you further diversify across multiple interest-rate environments.

For example, let's say you wanted to move money into the bond market right now. If you were willing to sink your money into a bond maturing in 10 years, you'd likely have to settle for a yield of 2% on a Treasury bond and less than 4% for an investment-grade corporate bond, quite low by historical standards. If bond yields went up before your bond matured, meaning that new bonds with higher yields became available, you'd have two choices, neither of them appealing. You could hold your bond until it matured in 10 years, thereby forgoing the ability to generate a higher income stream between now and then. Alternatively, you could sell your old bond and buy the new, higher-yielding one, but you wouldn't be able to sell it at face value.

A laddered strategy, by contrast, could help you combat that risk. You could invest a slice of your bond portfolio in a bond that won't mature for 10 more years, but put the rest of your money into bonds with shorter terms like six months, two years, three years, and five years. If interest rates trended up during the next decade, as in the example above, you'd come out ahead of the person who bought and held the 10-year bond because you'd be able to reinvest the proceeds from your shorter-term bonds into the newly available higher-yielding bonds.

The downside is that, if interest rates decline during the time you hold a laddered bond portfolio as they have during the past few decades, you'd have to reinvest maturing bonds at ever-lower interest rates, thereby reducing your portfolio's aggregate yield over the time that you held it. Your return would have been higher if you had simply purchased a higher-yielding, long-maturity bond at the outset of your holding period and sat tight until maturity.

Incredible shrinking yields are the key reason why many folks who had been employing laddered strategies have abandoned them in recent years. At the same time, some believe that yields can't go down much further from here and feel that the benefits of building a bond ladder today may outweigh the risks. However, because laddered bondholders are investing smaller sums into more bonds on a regular basis, their trading costs are apt to be higher than those of bond investors who take a concentrated, buy-and-hold approach.

Diversification does not eliminate the risk of experiencing investment losses. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes. Treasury bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while corporate bonds are not guaranteed. With corporate bonds an investor is a creditor of the corporation and the bond is subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade.

The Importance of Saving for Women

Women face a different set of financial-planning challenges than men because they tend to live longer, earn less, and take more breaks from the work force. Women may also experience more difficulties if they are widowed or divorced. The good news is that women tend to save more. According to Vanguard's "How America Saves 2012" report, women saved at rates about 5% to 10% higher than those of men across every income group. However, even though their savings rates were higher, women's balances in savings accounts tended to be lower than those of men because women, on average, had lower incomes. This illustrates the extreme importance that saving (and starting to do so early) has for women. It's not always easy, but managing debt, controlling expenses, and contributing to a retirement plan can make a world of a difference down the road.

Average Deferral Rates by Income and Gender 2011

Vanguard defined contribution plans permitting employee-elective deferrals

	Female	Male	All
<$30,000	5.1%	4.5%	4.8%
$30,000–$49,999	5.9	5.6	5.8
$50,000–$74,999	7.4	6.9	7.1
$75,000–$99,999	8.9	8.0	8.3
$100,000+	8.8	8.0	8.2

Source: Vanguard, 2012

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