Pettinga Insights and Outlook

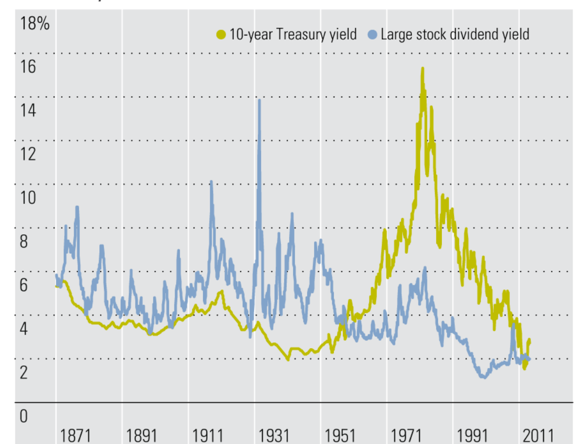
June 2014 | Vol. No. 1 | Investment Updates

Large Stock Dividend Yield Versus 10-Year Treasury Yield

In the recent context of likely-to-rise-at-any-time interest rates, it may be interesting to take a look at the historical relationship between stock and bond yields. As illustrated in the image, stock dividend yields were much higher than 10-year government-bond yields before 1957, with dividend payouts a form of compensation for the additional risk of investing in stocks.

In the more modern period, this relationship has changed. As capital appreciation became a bigger driver of stock performance, bonds became the main engine for potentially steady income generation. After 10-year Treasury rates significantly declined following the 2008 financial crisis, stocks yielded more than 10-year Treasury bonds for the first time since 1957. Recent rising interest rates, however, have pushed government yields above stock dividends once again.

Stock and Bond Yields
January 1871–March 2014



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Stocks are not guaranteed and have been more volatile than the other asset classes. Dividends are not guaranteed and are paid solely at the discretion of the stock-issuing company. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. U.S. government bonds may be exempt from state taxes and income is taxed as ordinary income in the year received. With government bonds, the investor is a creditor of the government. 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.

Data: Large stock dividend yield is represented by monthly S&P Composite Index. 10-year Treasury yield is based on the monthly yield of 10-year government bonds. Both indexes are from Robert J. Shiller's Data Library

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Monthly Market Commentary

Recent economic news was mixed, with strong U.S. auto sales and decent employment growth, but also with negative first-quarter GDP growth. The European Central Bank made headlines by lowering its key interest rates and announcing measures designed to ensure price stability and to support lending.

GDP: The U.S. economy contracted in the first quarter, after all. As many economists anticipated, first-quarter GDP growth was reduced from a 0.1% growth to a 1.0% decline. Although many categories shifted, it was inventories that really moved the needle. However, inventories are notoriously volatile, especially difficult to measure and to seasonally adjust. Wide swings in the data more likely represent measurement errors and timing issues and not necessarily things happening in the real economy. Given the solid growth rates in employment and consumption, the first quarter would have shown some modest growth if it weren't for the inventory subtraction.

Employment: The economy added 217,000 total jobs in May compared with the 12-month average of 194,000 jobs. Private sector jobs grew about 2.05% year over year, and the nonfarm payrolls, which add government to the mix, grew 1.72%. Both of those numbers are consistent with GDP growth in the 2.0%–2.5% range.

Total employment finally made a new all-time high and recaptured every job lost during the recession. It only took just under six and a half years, the longest recapture period in the post-World War II era. And that politely ignores the fact that the population is quite a bit greater than it was over six years ago. The performance has been very uneven, too, with many, many industries still operating below peak levels.

European Central Bank: Sagging economic growth and falling inflation finally forced the ECB to take decisive action to head off a Japan-like bout of deflation. Myriad rates were cut, negative interest rates were implemented for bank reserves, and new low-cost lending programs were rolled out. By putting a negative rate on deposits, the central bank hopes to force banks to lend more cash, which might generate more economic activity. All of this should stimulate the European economy and depress the euro, which would aid European exports. Equity markets around the world reacted well to this news. In general, easy money policies tend to help emerging markets, and the potential for a stronger export market in Europe provided a double dose of good news.

Housing Prices: Home price growth generally peaked last October and November, with the broader FHFA index down quite significantly and the CoreLogic data showing almost no change. Home affordability has slipped, mostly because of higher prices, but also because of higher mortgage rates. Less affordability means fewer transactions and less housing-related economic activity. The economy needs to work out a balance, with some level of price appreciation that keeps both investors and consumers in the market, but without so much price appreciation that no one can afford a home.

Consumption and Personal Income: Consumption growth, adjusted for inflation, dropped 0.3% in April, which was below expectations and is quite disconcerting taken in isolation. Incomes continued their nice upward slope, which should provide fuel for consumer spending in the months ahead.

Trade Deficit: The news on the trade front was not good, although monthly data can be highly volatile. The trade deficit for April was $47.2 billion, its highest level in the past two years and higher than the upwardly revised $44.2 billion for March. The widening deficit was a combination of a 0.2% decline in exports and a 1.1% surge in imports. Unfortunately, this data indicates further downward potential in the first-quarter GDP estimate and even more pressure on the second-quarter report.

Investing in Real Estate

Investors can gain access to commercial property through real estate investment trusts, or REITs. These trusts have attained attractive returns over the past 30-plus years, providing investors with the income earning potential of bonds and the price appreciation of stocks. With REITs, you may get the best of both worlds.

There are three types of REITs: equity, mortgage, or a hybrid of the two. Equity REITs invest in, or own, commercial real estate and use property rents as revenue. Mortgage REITs invest in loans secured by real estate, earning income through mortgage interest and fees. This article will concentrate on equity REITs, which make up a great majority of listed REITs, according to the National Association of Real Estate Investment Trusts (NAREIT). In fact, if you are interested in learning more about REITs, NAREIT can provide a lot of useful information.

A company must satisfy certain criteria before it can be classified as a REIT. First of all, the company has to be in the real estate business, and at least 75% of its assets must be real property. At least 75% of the company's revenue must come from real estate, and (this is rather important for investors) at least 90% of taxable income must be distributed annually to shareholders. For this reason, REITs can be considered good income-producing investments.

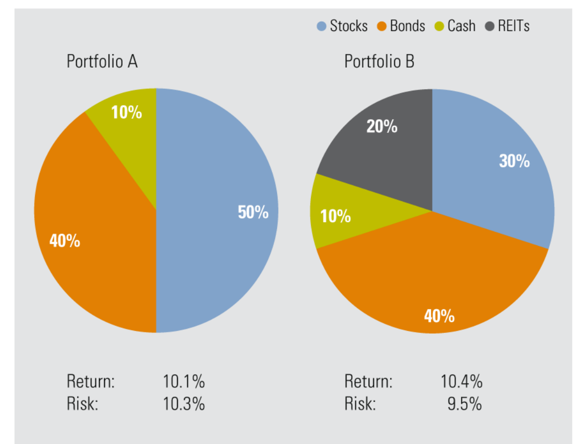
A portfolio of stocks, bonds and cash improves through the addition of REITs, due to the power of diversification. Because each type of asset does not react identically to the same economic or market events, combining them can often produce a higher return with less risk.

Take the example below. Portfolio A consists of stocks, bonds and cash. The portfolio's total return from 1972 to 2013 was 10.1% with a risk of 10.3%. Now look at Portfolio B, which had a 20% allocation to REITs over the same time period. Not only was its return higher at 10.4%, but its risk was also lower, 9.5%.

Nowadays, REIT investing does not have to be limited to the United States anymore. It's true that the U.S. still holds the largest percentage of the global real estate market capitalization, but more and more countries are introducing REITs, especially in Europe and Asia, creating more investment opportunities. Hong Kong, Japan, and Singapore are growing real estate markets in Asia, while the United Kingdom, France, and the Netherlands are developing in Europe.

Do keep in mind that diversification does not eliminate the risk of investment losses, and that REIT investments are not suitable for all investors.

Potential to Reduce Risk and Increase Return: Stock and Bond Investors 1972–2013



Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while returns and principal invested in stocks and REITs are not guaranteed. An investment cannot be made directly in an index. Past performance is no guarantee of future results. The average return and risk are represented by the arithmetic annual return and annual standard deviation, respectively. Standard deviation measures the fluctuation of returns around the arithmetic average return of the investment. The higher the standard deviation, the greater the variability (and thus risk) of the investment returns. Portfolios are rebalanced annually.

Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and REITs by the FTSE NAREIT All Equity REIT Index®.

Financial Aid for College: A Few Tips

Key to understanding financial aid eligibility is learning how financial aid formulas work. They're rather complex and vary from school to school, but they basically use answers to questions about family income, assets, and size to help arrive at a special number known as the expected family contribution, or EFC. The EFC represents the amount of tuition, fees, and other college costs the family is expected to cover based on its financial situation and other factors. Not all assets are counted when calculating the EFC (for example, assets held in retirement accounts don't count).

However, income plays a far greater role than assets in determining EFC. As much as 47% of income may be used in calculating a family's EFC, whereas parental assets are assessed at a maximum of 5.64%, and student-owned assets at a maximum of 20%. Financial -aid awards are based on the previous calendar year's income, so some families use strategies to reduce income the year before applying. For example, if one parent is considering retiring or going back to school, doing so will likely reduce the family's income, thus increasing aid eligibility. A parent also may ask that a work bonus be postponed to reduce income that counts against aid.

One common mistake families make is selling securities the year before the student enrolls as a way to cover college costs. But any capital gains from the sale count as income in the following year's financial aid calculation, so it may be best to sell securities the year before the base year (in other words, two years before the student enrolls), when the proceeds won't be counted as income.

This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

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