Pettinga Insights and Outlook

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Investors May ‘Prefer’ to Look Elsewhere for Yield

With yield so scarce today, investors are branching out into different asset classes in their search for income. Many investors have set upon preferred stock, a hybrid security usually issued by highly leveraged companies, such as financial institutions, telecoms, and utilities. Preferred stock has characteristics of both bonds and stocks. Like stocks, preferreds are traded daily on an exchange. Like bonds, they pay fixed income on a regular basis (usually quarterly), but typically they do not offer as much capital appreciation potential as common stock. In the capital structure, preferred stock is senior to common stock but junior to corporate bonds, and preferred shareholders have no voting rights.

Preferred stock is not without its headwinds. In fact, there are many significant risk factors that investors must consider. Heavy exposure to financials, regulation changes, and rising interest rates are foremost on this list. Preferreds are sensitive to interest rates, but unlike bonds, they are at risk in both directions. When rates fall (presently an unlikely event), issuers often call shares to reissue at lower, more favorable rates. When rates go up, preferred stock share prices fall. Preferreds also have call options backed in, usually about five years after issuance, but some can be called even before then. Issuers can suspend dividend payments during rough periods, and in the event of bankruptcy, owners will walk away with nothing (for example, investors in preferred shares from Fannie and Freddie lost everything). In conclusion, preferred stocks' high yields may be alluring to income-seekers, but investors should approach this space with caution.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than other asset classes.

Our Firm

Pettinga Financial Advisors, LLC is an independent, fee-only financial services firm serving clients across the nation from our office in Evansville, Indiana.

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

Overall, April data brought some very welcome good news. April auto sales looked great, stacking together two 16 million-plus unit sales months in a row. Pending-home sales looked much better too, indicating that the decline in existing-home sales may be nearing its end. Employment data looked great, but not perfect. Manufacturing continued to make modest progress with another month of increasing ratings from purchasing managers in the sector. Even chain store sales managed year-over-year growth of 3.1% in the latest period, their best performance since December.

GDP: First-quarter GDP growth was sharply below expectations, barely at 0.1%. Just about every category was flat or down, with only consumption of services saving the U.S. from an outright decline in GDP. However, a lot of data points from April (enumerated above) pointed sharply higher. All this may suggest that growth of 3% or more is possible in the second quarter, offsetting the sting of a disappointing first quarter. However, these numbers are not the start of a new normal of rapid and always-accelerating growth. Instead, growth for the full year is likely to remain stuck in a 2.0%–2.5% range.

Employment: April's nonfarm job growth of 288,000 plus revisions to the previous two months was a pleasant surprise. However, the longer-term trend, using an average of three months of data compared year over year, has not broken out of its slow upward trend, even with April's great performance. The report did contain one ominous dark could: Hourly wage growth was nonexistent for the second month in a row. Adjusted for inflation, the United States has seen two months of hourly wage declines. The inflation-adjusted wage data (combining employment, hourly wages, and hours growth) shows that the economy is still running a little below average.

Longer-term, we may be talking about job shortages, not the unemployment rate. The U.S.-born working-age population numbers (22- to 62-year-olds) are slated to decline for the first time in decades sometime in 2015. Spot shortages are already beginning to creep up in skilled machinists, airline pilots, and truck drivers (average age 55). Even homebuilders are complaining about a lack of skilled workers. Some of this is already becoming visible, with the unemployment rate dropping to 6.3% in April (from 6.7% the previous month). That rate could drop to under 6% by the end of 2014.

Housing: The housing market hasn't been doing well for some time, partially because of higher prices and higher mortgage rates and partially because of the weather. The numbers for March transactions, new and existing, were horrific. Still, there was one ray of hope with a decisive turn in pending home sales, which were up 3.4% in March, the first improvement in eight months. Pendings are generally a reliable predictor of existing-home sales. The gap between these two indicators is beginning to narrow sharply, so existing-home sales should be bottoming out soon, too. Also, better permits data points to improved housing starts in the months ahead.

Consumption and Personal Income: Consumption has been stuck at the 2% level for some time, but that number has begun to break out over the past two quarters. Spending growth is outpacing incomes again at a relatively healthy pace. While the two metrics can become untethered for a few months, longer-term they do tend to move in tandem. So in the months ahead, consumption will need to come down or incomes will need to come up.

Trade Deficit: Overall, the trade deficit narrowed to $40.4 billion in March from $41.9 million in February. Additional oil and gas production and shipments explain why the trade deficit has held steady or even improved over the past couple of years. Petroleum represents about 5% of all U.S. exports, which are up modestly over the past few years, while petroleum-related imports have fallen from 14% to 10% in real terms over the past three years.

Five Reasons to Let a Sleeping 401(k) Lie

Letting money sit tight in an old 401(k) plan is the path of least resistance, which is why many participants let their assets sit in the plans of former employers. This, of course, may be better than cashing the money out and spending it. Investors younger than 55 pay ordinary income taxes and a penalty on any premature distributions, which can diminish a 401(k) balance considerably. But there are also other reasons why staying put in a former employer's plan may be the best course of action.

1) Investors can't buy comparable investments on their own. One of the key reasons to stay put in a former employer's plan is if it offers investment options that are unavailable to smaller, individual investors. Institutional share classes of funds, which typically feature very low costs, are one such example. Another reason to leave money behind in an old 401(k) plan is to take advantage of a stable-value fund. This may be important for investors who are nearing retirement and looking to keep their portfolios steady, but not for younger employees who may not have such a great need for stability.

2) Investors may need early access to their money. Investors in 401(k) plans who have left their employers have another lever that IRA investors do not: the ability to tap their assets a touch earlier—at age 55 (Source: IRS 401(k) Resource Guide - Plan Sponsors, General Distribution Rules). To be eligible, workers must reach age 55 (or older) sometime during the year they retire. By contrast, IRA investors and 401(k) investors who retire before age 55 must wait until age 59 1/2 if they want to avoid the 10% early withdrawal penalty. Thus, for an investor closing in on that age who would like to have access to cash, staying put in the previous employer's 401(k) will make more sense than rolling the money over. However, it is a good idea to fully assess the portfolio's long-run sustainability before contemplating withdrawals at such an early age. Also note that some 401(k) plans may not allow the age 55 withdrawal option.

3) Investors could need the extra legal protections. Legal protections are another reason to consider staying put in an old 401(k). Although laws regarding creditor protections for retirement assets vary by state, company retirement plan assets generally have better protections from creditors and lawsuits than do IRA assets. Obviously, these protections will be a bigger consideration for those who have had credit or bankruptcy problems or who work in a profession where they may be sued.

4) Investors own company stock in their 401(k)s. When employees hold company stock in their 401(k) plans, staying put may offer a tax advantage versus rolling the money over. When company stock is held in a company retirement plan, stockholders pay capital gains tax on any appreciation over and above their cost basis when they sell the shares to take distributions in retirement (This differential is called net unrealized appreciation, or NUA). When rolling over the company stock into an IRA, on the other hand, stockholders pay ordinary income tax on the distributions they take when in retirement.

5) Investors may need the structure. Keeping the money in a 401(k) plan can provide at least a few safeguards. After all, these plans are overseen by fiduciaries who are legally required to look out for participants' interests, so the funds in the lineup tend to be well-diversified. However, investors should be aware that there may be differences in fees and expenses between 401(k) and IRA plans, and should investigate these fees and expenses carefully before making a decision.

401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Please consult with a legal, financial, or tax professional for advice specific to your situation.

Tune Out the Noise

There's a reason that investors tend to only hear about "looming" market doom or "imminent" market growth. While many news outlets have incentive to draw viewer attention with wildly bullish or bearish predictions, these sensationalized views may be a distraction to a sound investment approach. When tempted to make a radical change to your investment portfolio based on these headlines, it is important to recall some basic fundamentals to keep your plan on track.

Drown out the noise. Market movements are notoriously difficult to predict. The media outlets that scream the loudest are not always the most accurate. The fallout from attempting to time the market in response to one of these predictions can be dangerous to your portfolio.

Look, but don't stare. While it's important for investors to know the performance of their accounts, short-term market fluctuations can be quite volatile. While the probability of realizing a loss within any given day is high, the likelihood of realizing a loss historically has decreased over longer holding periods. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Stay focused on the long term. Investors who have taken the time to determine a sound investment plan based on specific goals and risk tolerances are best advised to stick to that plan. While it may not always grab headlines, a sensible, tailored investment plan may be the best solution to meeting long-term goals.

Holding a portfolio of securities for the long term does not ensure a profitable outcome, and investing in securities always involves risk of loss.

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