

Pettinga Insights and Outlook

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Not All Index Funds Are the Same

The choice to use index funds rather than actively managed funds is a significant one. Index funds tend to be rather straightforward, easy-to-own, and cost-effective investment vehicles. But, just like actively managed funds, index funds also have their differences that investors should be aware of.

Cost Still Counts. Different index funds can charge different fees. Funds that are otherwise virtually identical (meaning they track the same index) can nonetheless produce different returns based on their fees, because fund fees are deducted from returns. This cost difference can have a significant effect on fund performance when compounded over time.

The Challenges of Tracking an Index. Tracking error is the degree to which an index fund fails to mirror its benchmark's performance during a given time period. As the components and weightings of an index change

over time, the fund must buy and sell holdings in an attempt to match it, and some funds may do this better than others.

Subtle Index Differences. Index funds within the same category may not track the same index. Consequently, two index funds that may sound very similar could actually have very different portfolios and performance numbers.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should be read the prospectus and consider this information carefully before investing or sending money.

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The Many Faces of Risk, Part 2

The Risks You Do Take Are Manageable

The good news is, even if you have to take some short-term risks you'd rather not, you can take the edge off in a number of ways. Diversification among asset classes may reduce marketwide or so-called systematic risk. In 2008, the bond market held up just fine even though stocks uniformly fell on their face. Holding assets that move in different directions at the same time makes for a smoother ride overall and gives you more options should you need to liquidate a portion of your holdings for some reason.

You may also want to consider diversification within one asset class. Holding several stocks (as opposed to just one) from the same industry and other industries may reduce company-specific risk (such as product-launch failure) and sector-specific risk (such as e-books and e-mail taking a bite out of paper company profits). Another way to manage fundamental risk is to invest in companies that have sustainable competitive advantages.

Dollar-cost averaging, or putting your money to work in smaller chunks over time, may reduce that risk. It also happens to be the de facto way that most people end up investing—with a little bit of money coming out of every paycheck. Another way to potentially reduce price risk is requiring a margin of safety before buying. All else equal, if you like a stock at \$50 per share, you should love it at \$30. Buying at a discount means you have room for error in your analysis, a buffer in case of an unforeseen complication, or the chance for extra return if everything goes as planned.

Don't Let Risk Take You

Unlike the familiar risk of going to work for an immediate reward (a paycheck), when it comes to investing, the reward is typically delayed, while the perceived risk (specifically market volatility) is immediate. Because of short-term market gyrations, investors may also feel that they can't control or moderate their investment risk. So, there is a disconnect between perceived high and uncontrollable present risk on one side, and an uncertain future reward on the other. That just doesn't sound like a

good trade-off.

But that story is not complete. You also have to think about shortfall risk and the opportunity cost of not investing (in other words, the money you could have made over time but didn't because you weren't invested). You have to think about the cost of inaction, because not taking any action is potentially risky, too, just in a different way.

When you look at it this way, you should realize you can't avoid risk. So, don't let risk just happen to you. Since you'll end up taking risk in one form or another, you might as well take control, and take smart risks. Take risks in a way that you choose, in a form that you manage to reach your goals—knowing the trade-offs and the consequences and the rewards.

There is no guarantee that diversification, asset allocation and dollar-cost averaging will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. In addition, since investing by dollar-cost averaging involves continuous investment in securities regardless of fluctuating prices, investors should consider their financial ability to continue purchases through periods of both low and high price levels.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than bonds. Investing does not ensure a profitable outcome and always involves risk of loss.

This is for informational purposes only and should not be considered financial planning advice. Please consult a financial professional for advice specific to your individual circumstances. This article contributed by Christine Benz, Director of Personal Finance with Morningstar.

Monthly Market Commentary

In recent economic data, employment matches expectations, manufacturing flattens after a period of decline, and auto sales growth continues to moderate.

Employment: The U.S. economy added 223,000 jobs in April, matching expectations. However, it wasn't all good news; the March estimate was reduced from 126,000 jobs added to just 85,000, providing a much easier set of goalposts to hit for the April report. Furthermore, hourly wage growth, at least on a month-to-month basis, was surprisingly weak with just 0.1% growth or 1.2% annualized. On the positive side, the unemployment rate continued to trend down, ending April at 5.4%, down from 5.5% a month ago and 6.2% a year ago. This is the lowest reading in seven years. For a change, the rate went down exclusively because new jobs were added even as 166,000 people entered the work force in April. The higher percentage of people looking for jobs is a sign of increased consumer confidence.

Looking at private sector job growth, which excludes the much slower-growing government sector, the three-month average, year-over-year growth rate remains relatively high at 2.6%, which is down just a touch from recent highs and still above the 2.4% average growth rate of the past 12 months. Those year-over-year growth rates are likely to continue deteriorating modestly in the months ahead.

GDP: The U.S. GDP report of just 0.2% GDP growth in the first quarter was disappointing to everyone, as falling oil drilling activity ruined a report that was already expected to be hit hard by bad weather and West Coast port-related activities. Drilling activity pushed GDP growth down by 0.8%, about the size of the negative surprise. Still, we wouldn't be too upset with a GDP report that shows four-quarter-over-four-quarter growth of over 3%. Seasonal factors and weather have really confounded economists and statisticians, who tend to favor the sequential quarter-over-quarter growth methodology.

The individual GDP component factors weren't too far off of consensus forecasts. Consumption growth was cut in half in a widely expected drop from 4.4% to just 1.9% growth between the fourth quarter and the

first quarter. At almost 70% of GDP, that fall single-handedly took off 1.7% from the GDP growth rate (contribution from 3% to 1.3%). The rapid deterioration in consumption, however, was widely expected. Morningstar economists still predict that U.S. GDP will grow at a rate of 2.0%–2.5% in 2015.

Manufacturing: The overall ISM Purchasing Manager Index, a great leading indicator of manufacturing activity, was flat in April at 51.5, after falling for five consecutive months. At a reading of 51.5, the metric shows that more businesses are seeing an increase in activity versus a decline. Still, the number, at least on the surface, disappointed analysts who expected a weather- and port-related bounce to 52.2. That said, the April report was a bit stronger than it looked. New orders—the leading part of the index—increased from 51.8 to 53.5, and current production moved from 53.8 to 56. Exports and imports also showed nice increases, though these are not used in calculating the composite index.

Auto sales: While auto manufacturers were trumpeting good April numbers, the auto recovery is looking a little long in the tooth. The auto sales for April were about 16.5 million units, which marks a 3.1% annual increase. That's down from the 3.8% rate reported in March. It is now apparent that auto sales growth has peaked and further year-over-year increases will be modest, indicating that the auto industry will have limited impact on GDP and employment going forward.

Retirement Distribution Pitfalls: Income-Producing Securities

Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be relying strictly on income-producing securities to meet income needs. Sticking exclusively with income distributions can leave retirees beholden to the current interest-rate environment. We've seen that problem in sharp relief during the past several years, as income-oriented investors have been forced into riskier areas, such as emerging-markets bonds, to scare up the income they need.

Workaround: The bucket approach to retirement

income is essentially a total-return approach that relies on regular rebalancing to provide income for living expenses. Using such a structure, a retiree would own bonds and dividend-paying stocks but would also own other stock types, including those that don't pay dividends. Such a strategy could potentially provide a better-diversified portfolio than the income-only approach for some retirees, and may also allow a retiree to enjoy a fairly stable standard of living.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Diversification is an investment method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and 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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