Pettinga Insights and Outlook

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The Flavors of Investing

It is tempting to jump on the investment bandwagon when certain parts of the market soar based on a trend or analyst report. While great potential exists, sector investing can also come with great risk.

As seen in the image, what is hot one year isn't always hot the next. Interested investors should be willing to follow a sector's ups and downs, as timing the market is difficult. Investing in specific sectors can add volatility to a portfolio, but exposure to the right sectors can contribute to improved financial performance. Keep in mind that while sector investing can fill a gap or serve as a speculative play, a balanced asset allocation should be the core of any portfolio.

10-Year Sector Winners and Losers

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Highest return	4.3	50.3	38.1	40.8	39.4	32.9	–16.1	61.9	30.5	18.5
	–6.3	41.0	32.1	14.8	36.2	27.5	–23.3	53.6	27.4	13.4
	–6.6	37.6	23.3	12.2	21.8	17.2	–28.1	50.2	24.9	11.9
	–9.1	37.3	19.2	8.1	19.7	16.6	–38.2	35.6	24.2	6.9
	–13.1	34.8	17.9	6.0	17.6	12.6	–38.4	34.0	23.4	5.1
	–21.1	32.1	15.4	6.0	15.4	12.0	–39.4	29.3	23.2	4.1
	–23.6	26.1	14.4	5.2	15.1	8.0	–39.8	24.0	14.5	0.6
	–23.8	24.7	12.5	3.7	15.0	0.2	–41.2	21.0	13.4	–0.4
	–23.8	19.8	10.1	3.0	11.9	–8.7	–42.0	15.6	11.8	–0.7
	–37.3	18.9	3.5	–1.4	10.9	–17.9	–48.1	14.5	7.3	–14.1
Lowest return	–38.3	17.4	0.8	–6.0	6.7	–18.3	–51.3	11.8	5.1	–16.5

Basic Mat.
Comm. Ser.
Cons. Cyclical
Cons. Def.
Energy
Financial
Health Care
Industrials
Real Estate
Technology
Utilities

This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Sector investments are narrowly-focused investments that typically exhibit higher volatility than the market in general. Sector investments will fluctuate with current market conditions and may be worth more or less than the original cost upon liquidation. Returns and principal invested in stocks are not guaranteed.

Source: Sectors in this example are represented by the Morningstar Sector Indexes.

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Mark Pettinga, JD, CFP®

mark@pettinga.com
812-436-4000
www.pettinga.com

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Monthly Market Commentary

In early September, the European Central Bank took steps to ease monetary policy and China introduced new infrastructure stimulus measures, as economic news in both regions continued to show signs of slowing. Both these actions have led many to expect the Federal Reserve to do the same with some form of quantitative easing, following poor manufacturing data and a softer-than-expected employment report in August. Morningstar economists believe that lowering rates further may do little to help the economy. Corporations are already awash with cash, while consumers are still finding it difficult to get loans at these low rates. Furthermore, commodities are on the rise again with gold setting a five-month high, and oil prices moving higher.

GDP: Second quarter real GDP was revised upward to 1.7% from 1.5%, which typically means that things were stronger in the last month of the quarter than originally anticipated. Overall, consumer spending was revised up, exports also improved (despite turmoil in Europe), and government spending shrank less than previously estimated. Although the quarter-to-quarter data over the last 2 years continued to be extremely volatile (ranging from 0.1% to 4.1%), the year-over-year data shows GDP growing at a slow but consistent pace (1.6% to 2.8%).

Employment: August saw a disappointing 96,000 jobs being added, down from 163,000 jobs in July. Morningstar economists have highlighted a few inconsistencies over this data: at a time when new and existing home sales were up, the report indicated construction employment did not grow at all. Also, the employment at building material and garden centers was reported to have fallen by almost 10,000 people, which Morningstar economists felt was unlikely, given the better construction market. An unusually large number of employees (380,000) left the workforce in August, which caused the unemployment rate to drop to 8.1% from 8.3%. Morningstar economists believe that this was mainly because of students returning to school from their summer jobs. While seasonal adjustment factors are typically supposed to capture this change, many schools and universities are shifting the start of their school year earlier in August. The high dropout rate could also have come from more employees quitting, or ceasing to look for jobs, to go back to school due to poor economic prospects.

Housing: The housing recovery has continued long enough that both leading indicators (pending home sales) and lagging indicators (Case-Shiller Home Price Index) were moving in the same positive direction. July pending home sales jumped 2.4% compared with June and 12.4% compared with July 2011. It is important to note that pending sales have been higher than closed sales all year, as the failure of homes to appraise at the agreed-upon price and tight lending conditions are holding back closings. In June, the Case-Shiller 20-city index increased 0.5% on a year-over-year basis, which marked the first year-over-year increase in two years. Although the index just broke into positive territory, the improving trend has been in place for six consecutive months. Month-to-month data showed a 2.3% increase, and all 20 cities in the index showed home price improvement.

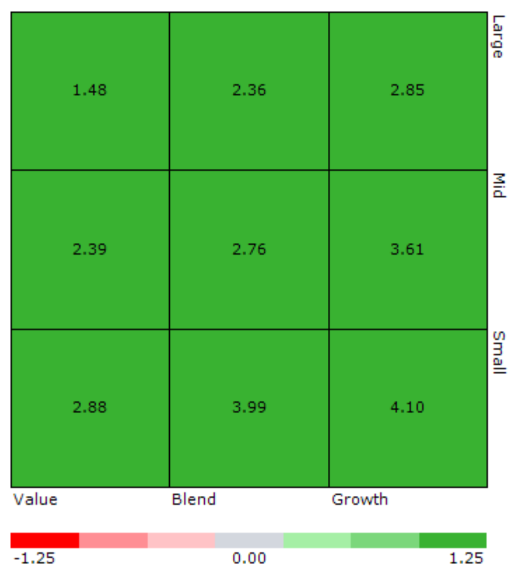
Manufacturing: U.S. manufacturing in August continued to slow, as new orders fell and inventory levels increased. However, auto sales accelerated to 14.52 million units in August, the best performance since the cash-for-clunkers promotion in 2009. Year-over-year sales growth of over 20% was inflated by a strong recovery from Japanese brands that suffered supply shortages last August because of the tsunami. Pent-up demand and low cost has also resulted in the Detroit Big Three reporting year-over-year gains of more than 10%, mainly from pickup truck sales. Outside the U.S., manufacturing in Europe continued to weaken, including Germany, because of softer orders from China. China's manufacturing sector also underperformed, reporting its lowest level since 2009.

Keep Your Cool

The stock market is a fickle thing, and risks are inherent for everyone who puts money in it. Only a few years ago, during the 2007-2009 financial crisis, many investors saw their portfolios melt away under their very eyes in an extremely short period of time.

It's normal to panic in such a situation, but the problem is the following. If you panic, take all your money out of the stock market to cut your losses, and place it into cash, you probably don't have any chance of recuperating your loss ever again, because returns on cash are about as low as you can get in the investment world. If, on the other hand, you keep your cool and stay in the stock market, chances are the crisis will pass and stocks will probably go up in value again. Of course, nothing is guaranteed, but panic won't help you in any case.

Monthly Market Barometer



1 Month, ending August 31, 2012. The U.S. Market returned 2.47% (YTD 13.31%).

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are "value" and "growth" while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.

The Art of Asset Location

Asset location is a part of the investing strategy that involves deciding which investments to hold in which accounts, and taxes play an important role in this decision. Here are a few basic guidelines.

Hold in Your Tax-Sheltered Accounts: Assets With High Tax Costs. In general, government or corporate bonds and bond funds may be a better fit for tax-sheltered accounts (like IRAs and 401(k)s) than for taxable accounts because their payouts are taxed at an investor's ordinary income tax rate. If you need to hold bonds in your taxable accounts, a municipal bond or municipal bond fund might offer you a better after-tax yield than a taxable bond investment, because income from munis is exempt of federal income taxes.

Hold in Your Taxable Accounts: Assets With Low Tax Costs. By contrast, stocks and stock funds may generally be a better bet for taxable accounts. Long-term capital gains, which is what you have when you sell a stock that you've held for at least a year, are taxed at a much lower rate than bond income (however, these favorable tax rates are set to expire at the end of 2012).

Stocks are not guaranteed and have been more volatile than the other asset classes. Dividends are not guaranteed. Bonds are subject to credit/default risk and interest-rate risk. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes apply to any capital gains distributions. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. 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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Mark Pettinga, JD, CFP®

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

mark@pettinga.com
www.pettinga.com

Tel:812-436-4000
Fax:812-436-4004