Our Two Cents

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Five Lessons from the Three-Year Market Rally

…now a four-year market rally, but the lessons are still relevant. 1) The turning point is not always obvious. In hindsight, it seems like it should have been dead obvious that stocks were cheap four years ago. But, because of their inability to clearly identify market bottoms, investors may be better off sticking with a strategic asset-allocation plan. 2) Don't let past performance control your portfolio. To the extent that you can, let your strategic asset-allocation framework be a key driver of where you deploy new cash. 3) To help maximize participation, make a little room for the risky stuff. Even though higher-quality stocks tend to hold up better during downturns, the opposite tends to be true during recoveries. Investors may want to maintain exposure to both types of companies: high-quality, wide-moat dividend payers and economically sensitive small- and mid-caps. 4) But there are also chicken ways to play. You don't need to pile on the risk to generate robust gains in absolute terms. Investors who have shorter time horizons or are simply more comfortable with lower-risk stocks can reasonably allocate more toward such stocks without completely ceding their upside potential. 5) There will be bumps (and buying opportunities) along the way. The movement hasn't always been upward since the market bottomed. If your portfolio is light on stocks at the outset of a rally, periodic sell-offs may provide opportunities even at a later time.

Diversification and asset allocation do not eliminate the risk of investment losses. Stocks are not guaranteed and have been more volatile than other asset classes. Small stocks are more volatile than large stocks, are subject to significant price fluctuations and business risks, and are thinly traded. This should not be considered financial planning advice. Please consult a financial professional for advice specific to your individual circumstances.

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What can we expect next?

Surely not a simple answer. Let us look at a few facts and trends:

• The bond market (Barclay's US Aggregate Index) had its worst loss in 14 years and was down for only the third time in 28 years.
• There were 30 years when the Dow's returns exceeded 25%, with 23 being followed by another positive year. So, based on history, there is a 77% probability of another positive year in 2014.
• It was the 18th year in S & P 500 history with a price return of over 25%. On average, the return following was a positive 6%.

Thoughts for next year:

• The second year of a presidential cycle is the worst historically. For what it is worth, the second year's returns are even lower than the average when the President has been a Democrat.
• Stock valuation is on the watch list, although not yet troubling. At the end of 2011, the forward P/E was 12.9 and was expanded to 15.7 at the end of 2013.

The bull market shows signs of continuing, but there remains a risk of correction in the near-term.

529 Plan Participants Deserve Better Disclosure

College savers need to be aware of many details when choosing a 529 plan, yet often the information either isn't provided or takes too much digging to find. A recent Morningstar study of 529 plans' disclosure found that the typical 529 plan website and plan document provide only high-level descriptions of the investment options. Basic information, including the name and tenure of the portfolio managers running the 529 investment options and details about the most recent portfolios, isn't required disclosure for 529 plans.

What Investors Need to Know for Static Options: Static 529 plans are plans whose investment allocation does not change over time. Unlike the age-based options (discussed below), they do not move to a more conservative allocation mix as the beneficiary approaches college age.

For static options, crucial information includes how much the option costs, who manages the portfolio and how experienced they are, what the investment strategy is, what the portfolio owns, and what the performance record is.

For stock fund portfolios, it's good to know whether an investment is primarily exposed to big or small companies, or firms in a specific sector of the economy, like health care, technology, or energy. This information may help investors and advisors anticipate how an investment will perform and identify potential risks. With bond portfolios, it is important to look at credit quality and interest-rate exposure to broadly understand how the plan will perform in different market environments. For example, a portfolio with low credit quality may outperform in bull markets, when investors are less risk-averse, but it could post steep losses in a downturn.

What Investors Need to Know for Age-Based Options: Age-based options hold the majority of 529 assets and have a similar structure to the popular target-date mutual funds found in retirement savings plans. Age-based options' asset allocation becomes more cautious over time, moving college savers' assets from primarily stocks when the beneficiary is young to primarily bonds and cash as college enrollment nears.

For an age-based option, necessary disclosure should include how much it costs and who's managing the portfolio, but also a description of the asset allocation strategy, the strategies of the underlying holdings, and the performance record.

Morningstar's study showed that few 529 plans provide this valuable information. Professional investment researchers can dig it up by cross-referencing 529 investments with data on the plan's ultimate mutual fund holdings, but college savers would be much better served if this portfolio and manager information were easily accessible.

Transparency Matters: Better informed investors can make better investment decisions, but most 529 plans aren't providing the basics that college savers and their financial advisors need to make informed choices. Just as mutual fund investors can get access to the appropriate data to monitor and evaluate a fund, college savers deserve an equally high standard of transparency. Importantly, the data should be timely and easily accessible. Examples of good disclosure exist in both the 529 plan and mutual fund industry, so plans with poor transparency should emulate the disclosures of their peers.

529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax. Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns. An investor should consider the investment objectives, risks, and charges and expenses associated with municipal fund securities before investing. More information about municipal fund securities is available in the issuer's official statement, and the official statement should be read carefully before investing.

529 Plans: State Benefits

Among the most attractive benefits of a 529 college-savings plan are the tax breaks savers receive while building a nest egg to pay for a child's education expenses. 529 plan participants can avoid paying federal taxes on their 529 savings' gains, but many states offer local benefits on the initial 529 contributions, as well.

Morningstar recently tallied the states' benefits to determine which states offered the most generous local tax breaks. By quantifying these benefits, college savers are better able to determine whether their home state's 529 plan is a good choice. Generous tax benefits and fee waivers may offset other shortcomings in a plan, like higher expense ratios or mediocre investments options. Likewise, if a state's tax benefits are little to none, college savers have little reason to stay with their state's plan and may instead seek a better one elsewhere.

Morningstar found a wide range of benefits. Eight states (California, Delaware, Hawaii, Kentucky, Massachusetts, Minnesota, New Hampshire, and New Jersey) tax their residents' income and offer no state tax benefits. Residents in these states often invest elsewhere and are actively targeted by other states' 529 plans. On the flip side are states that offer portable tax benefits. Residents of states such as Maine, Kansas, Missouri, Pennsylvania, and Arizona receive benefits on their contributions to any 529 plan, not just the ones offered by their home state. For most 529 savers, however, their state's tax benefits are not portable, so if they choose another state's plan, they give up the local tax breaks.

Topping Morningstar's list of the states with the most generous 529 benefits is Indiana. While most states with tax benefits allow their residents to subtract their 529 contributions from their taxable income, residents of Indiana get something far better: a tax credit. This credit of 20% of the first $5,000 of 529 contributions allows them to subtract $1,000 from their annual state tax bill. When you also include two $20 account-fee waivers, Indiana residents can save $1,040 on $5,000 in annual 529 contributions by staying in-state. (Vermont and Utah also offer tax credits on 529 savings, but they're not as generous as Indiana's.)

Maine is another state with solid benefits, but much of them expire after the child's first birthday. Maine residents get a $500 grant from their state if they open a 529 account before their child's first birthday. From there, however, the Maine benefits are less generous. Residents may deduct from their taxable income just $250 per child in annual 529 contributions.

Beyond Indiana and Maine, six states offer benefits in the $400 to $500 range, and more than a half dozen are $300 to $400. The states with greater benefits, like Iowa and Oregon, often also have higher tax rates.

A handful of states offer smaller benefits. Some states, including Arizona, hold benefits in check by limiting the amount of 529 contributions that qualify for deductions. These smaller benefits, when expressed as a percentage of the overall 529 investment, can add up, but 529 savers may choose to give up smaller benefits in favor of a better plan elsewhere.

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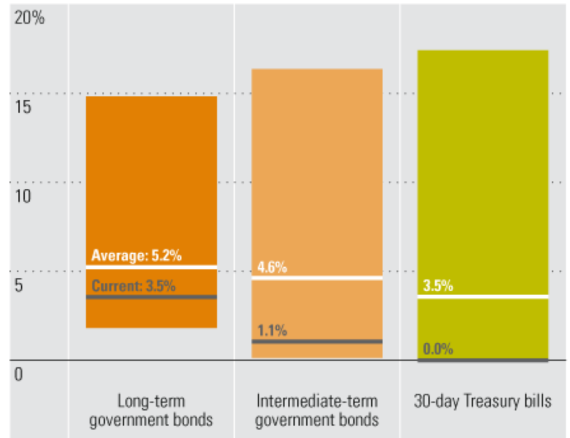
History of Interest Rates

It is commonly known that interest rates have been at historically low levels for a few years now. But how low are they? The image illustrates the characteristics of interest rates of various maturities. On average, long -term government bonds delivered the highest yield of 5.2%, while intermediate-term government bonds and 30-day Treasury bills provided an average yield of 4.6% and 3.5%, respectively. Current interest rates are positioned relatively close to the all-time lows, especially on the lower end of the maturity curve.

A rising interest rate environment seems to be the generally accepted forecast for the future. While rates can't drop much lower from their current level, the timing and magnitude of the rise still remains highly uncertain.

History of Interest Rates
January 1926–November 2013



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Indexes are unmanaged and not available for direct investment. 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: The long-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Long-Term Government-Bond Yield Index. The intermediate-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Intermediate-Term Government-Bond Yield Index. The 30-day Treasury bill yield series uses annualized monthly Ibbotson SBBI U.S. 30-Day Treasury Bill Total Return Index.

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