Our Two Cents

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Politics and Investment Performance

With President Obama's first term in office coming to a close, here's the result of an investigation into the relationship between the composition of the legislative and executive branches of the U.S. government and market performance. The "unified" situation refers to years when the Senate, the House of Representatives, and the White House were all controlled by the same party. The "partially divided" situation represents years when the House and Senate were controlled by the same party, but the White House was held by a different party. The "completely divided" situation uses data from years in which the two houses of Congress were divided. Both the S&P 500 and the diversified portfolio (60% stock/40% bond) averaged the highest returns during unified years, lower returns during partially divided years, and the lowest under completely divided years.

Average Annual Returns 1926–2011

	S&P 500	Diversified portfolio	Number of years
"Unified" years	14.8%	9.9%	45
"Partially divided" years	11.1%	9.5%	30
"Completely divided" years	1.1%	7.4%	11

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. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. The time period examined is 1926–2011, and the returns are average annual returns.

Stocks—represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds—20-year U.S. government bond.

Advisor Corner

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Interesting information on our cover article on politics and investments. The presidential election is right around the corner and hopefully you have been engaged in doing your research. I can not recall more diverse paths for which the candidates propose to take the country. It looks to be a very close race and as always encourage you to participate in our democratic process.

Mixed Income

Fixed-income performance reversals are common: It is extremely difficult to predict which category of bonds will be the best or worst performer in any given year. The performance of any fixed-income investment can have drastic periodic changes. Investors could potentially diminish their returns by attempting to follow last year's winner.

Furthermore, investors who have an asset allocation policy consisting of different asset classes such as stocks and bonds may still not be diversified. Therefore, branching out within each asset class may further lessen overall portfolio risk.

Diversified bond funds might alleviate portfolio volatility: The image illustrates the performance of various fixed-income instruments in relation to one another from 2002 to 2011. The data shows it is impossible to predict the winners for any given year. For example, high-yield corporate bonds were the worst performers in 2007 and 2008, but rose to become the best-performing investment in 2009 and 2010. While aggregate bonds have never been the top performer in any of the years examined, their performance has remained fairly consistent, with minimal swings when compared with other categories such as long-term and international bonds.

It can be beneficial to hold a fund that is diversified across several types of bonds. This might reduce portfolio risk while allowing for more consistent performance over time.

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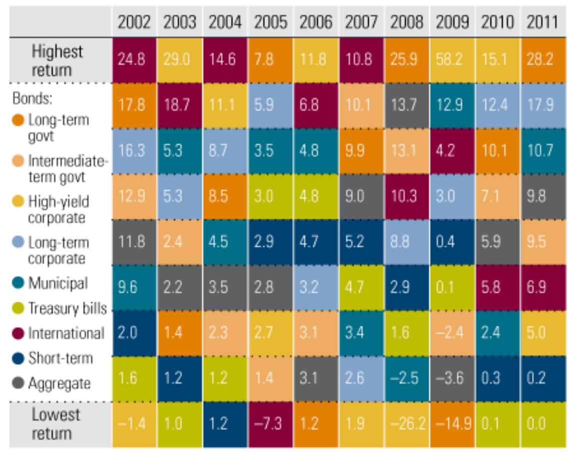
Fixed-Income Winners and Losers

Performance of Various Fixed-Income Investments



Source: Long-Term Government Bonds—20-year U.S. government bond; Intermediate-Term Government Bonds—5-year U.S. government bond; Treasury Bills—30-day U.S. Treasury bill; High-Yield Corporate Bonds—Barclays domestic corporate high-yield bond index; Corporate Bonds—Ibbotson Associates long-term high-grade corporate bond index; International Bonds—Citigroup non-U.S. world government bond index; Municipal Bonds—Barclays municipal bond index; Short-Term Bonds—Barclays short treasury index; Aggregate Bonds—Barclays aggregate bond treasury index. An investment cannot be made directly in an index.

Know Your Own Inflation Rate

The Consumer Price Index (CPI), a measure of inflation, is a monthly statistic representing the change in prices paid by urban consumers for a representative basket of goods and services. While this measure serves more as an official gauge, a lot of consumers (especially retired consumers and investors) seem to have a different sense of inflation. The question often arises: Why is it that the official rate seems to be lower than what we're actually feeling out there?

Our inflation rate may vary depending on our individual expenditures. This means that some people may experience higher inflation relative to others. For a senior, food and energy costs are a very high proportion of their total household outlay. The location where you live can also impact your personal inflation rate. If you have a fixed-rate mortgage, or if you're retired and your home is paid for, you won't experience fluctuating housing costs as a result of having an adjustable-rate mortgage or paying rent. But you may see housing costs vary from one region of the country to another. Another big swing factor in your personal inflation rate is health-care cost. If you have purchased a long-term care policy with an inflation rider, you can insulate yourself against rising nursing-home and other long-term care costs.

Anyone who has Social Security has a buffer against higher prices because Social Security includes a cost-of -living adjustment. If a Social Security paycheck is a big proportion of your total income needs, you're likely in good shape as far as inflation is concerned. If it's just a tiny portion of your total income needs, you're not in as good a shape. If you're receiving a pension with an inflation adjustment it can help you stave off inflation, and the same goes for folks who have an annuity with an inflation rider; they will have some protection against inflation. What about folks who are still in employment? If you're still working, either full-time or part-time, you may potentially be able to get a cost-of-living adjustment in your paycheck. If you're not working and not eligible for those cost-of-living adjustments, you'll need to plan for inflation accordingly.

Finally, it's also important to gauge whether your portfolio is built to withstand your personal rate of inflation. Portfolio composition is the key here. Investments such as short-term bonds and cash may not safeguard against the threat of inflation. If a high proportion of your portfolio consists of cash or short-term bonds without any inflation protection built in, you may see a large percentage of your return eaten away by inflation. Next up is your portfolio time horizon. Seniors who are quite far into their retirement and don't anticipate having a long time horizon for their investment assets probably need to be less concerned about the toll that inflation will take over time. However, if you're just starting out in retirement, you may need to plan for inflation-proofing your portfolio, because over time, even a seemingly benign inflation rate of 3% may take a bite out of your portfolio return.

Diversification does not eliminate the risk of experiencing investment losses. 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, while stocks are not guaranteed and have been more volatile than other asset classes. Annuities are suitable for long-term investing, particularly retirement savings. Annuity risks include market risk, liquidity risk, annuitization risk, tax risk, estate risk, interest-rate risk, inflation risk, death and survivorship risk, and company failure risk. Withdrawal 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. Additional fees and investment restrictions may apply for living-benefit options. Violating the terms and conditions of the annuity contract may void guarantees. Consult a financial advisor and tax advisor before purchasing an annuity.

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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