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Volatility Returns, and Not In a Good Way

They say the stock market conspires to frustrate the greatest number of investors at any given time, especially in the short run. Coming off 2011's meager results, the first quarter of 2012 was one of the strongest in many years for mainstream equities. But at this writing much of the gain has been washed away in the market swoon over the stubborn euro zone crisis, weaker jobs numbers, a disappointing Facebook IPO, and, well, pick your poison.

Much of this is reminiscent of another summer 20 years ago. Like 2012, 1992 was shaping up as a contentious election year, and negativism often reigns during that quadrennial mudfest. That summer the *Client Quarterly* asked "Is the Good Old U.S. Really Doing that Badly?" Many of the concerns challenged in that article linger today: outsourcing of jobs, faster growth in emerging nations, the lingering drag from a recent recession, budget and trade deficits, political gridlock, and pressures brought on by technology and economic dislocation.

As it turned out, the 1990s proved to be a very American decade indeed. Political gridlock, the "peace dividend," and demographic factors cut the growth rate of federal spending in half, and a late-decade revenue surge brought the budget to surplus for the first time since the 1960s. The emergence of the Internet spawned countless new ventures and waves of capital investment by established companies. Once the party really got going, the Standard & Poor's 500 Index booked a cumulative total return of 251% in just five years (1995-1999).

The market's latest bout of distemper has been deepened by apparent weakening in the pace of U.S. job creation. May's number was so surprisingly disappointing that it prompted some to wonder whether the seasonal adjustments that are applied to those numbers are out of whack. After all, on a *non*-seasonally adjusted basis, the Bureau of Labor Statistics reported non-farm payrolls up nearly 800,000 in May.

Some have suggested that the unusually mild winter across much of the nation, coupled with those statistical seasonal adjustments, might have artificially boosted the jobs numbers for the winter months, which may in turn be making the spring numbers look weaker.

Year over year those adjustments should even out. Nonfarm payrolls are up about 1.8 million from a year ago, and about 2.8 million from two years ago. That's still roughly four million jobs shy of the peak levels of 2007, a tepid recovery by historical standards but better than some of our cousins across the pond.

Americans at Work

Total Non-farm Payrolls (in 000s)

May of...	*Seasonally Adjusted*	*Not Adjusted*
2006	135,891	136,584
2007	137,612	138,277
2008	137,446	138,045
2009	130,985	131,626
2010	130,188	130,833
2011	131,227	131,889
2012	133,009	133,727

Source: U.S. Bureau of Labor Statistics

Meanwhile, demographic trends and changes in the nature of work itself are making it tougher to figure out exactly how many folks we really should expect to see in the job market these days, and how best to account for them.

A recurring theme of these pages has been the rising importance, for both major companies and U.S. investors, of economic growth in *other* parts of the world. Given the gathering clouds over that bigger picture, a little market turmoil is hardly surprising. As the litany of current concerns saturates the media, there are always opportunities at hand. A few years from now we may be looking back and wondering how we managed to miss them. They just tend to be harder to spot at such close quarters. ■

State Budgets Are Mostly on the Mend

Today's headlines are dominated by governments in desperate financial straits. So it's encouraging to read that most states are seeing some improvement on the fiscal front.

As we noted in our Fall 2010 issue, many states are constitutionally proscribed from borrowing to fund operations. State and local governments have trimmed more than 600,000 workers from their payrolls since mid-2008. Those cutbacks have leveled off, but the belt tightening contrasts sharply with the federal government.

Meanwhile, tax receipts have been staging a comeback. The fourth quarter of 2011 saw state tax collections beat their best pre-recession fourth quarter which was in 2007. The *Wall Street Journal* recently reported that the aggregate budget shortfall for the 50 states is projected at $47 billion for the fiscal year that starts this July, down from $106 billion for the current year and a peak of $191 billion in fiscal 2010.

There are still significant stresses out there. Some high-profile states

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Taking Stock Ten Years Later

Ten years ago this summer, equity markets were traversing the worst patch of the post-Tech-Bubble bear market. It was a time for reassessing investment strategies and economic realities. Inflation appeared to be well contained in the face of rising global productivity. The Fed had pushed short-term interest rates below 2% in the face of weak employment growth, and pessimism prevailed in most quarters.

That summer's *Client Quarterly* noted that "thinking in these terms takes some getting used to after more than two decades in which there always seemed to be someplace one could reach for double-digit returns."

One of the more critical elements of effective financial planning is the setting of realistic expectations. That article went on to note that "in the context of broadly diversified equity and fixed income holdings, solid single-digit returns may be considered pretty respectable for a while, especially in real terms." The accompanying Performance Summary for major mutual fund categories shows how that suggestion actually played out. ■

► *continued from page 1*

State Budgets...

such as California, Illinois, and New York remain in the throes of their own fiscal crises. Even with broad improvement in the current picture, many states and localities face long-term challenges from pension and health care costs. For the coming fiscal year 29 states still project deficits, while 42 were in the red last year.

Not long ago some market observers predicted waves of defaults that would swamp the municipal bond market. Investors who stuck with diversified portfolios of munis can take some comfort in the response of many of those governments to tough times. And they booked some pretty respectable returns. ■

A Close Look at the Performance Chase

One of this publication's persistent themes is the caution against chasing hot performing investments, especially when the chase competes with effective diversification and risk control. But you don't have to take our word for it. Morningstar Investment Services, the money management arm of the highly regarded investment research firm, recently conducted a comprehensive review of active and obsolete U.S. equity mutual funds for the 19-year period ended January 31, 2009.

Morningstar carefully constructed peer groups for all the funds in its database at each point in time, then calculated category percentile rankings for each fund's rolling three-year returns. To gauge the predictive value of those three-year results, Morningstar looked at the top-quartile funds in each of those three-year periods to see how they fared in the *subsequent*, non-overlapping three-year stretch.

In most categories the top-quartile performers in a given period did not fare as well against their competition in the subsequent period. In fact, the average top-quartile fund often went on to underperform its category average. The exception was in the small-cap growth stock category, but even that propensity appears to have faded in recent years.

There's really nothing special about three years. However, having a track record at least that long is often a threshold qualifier for investment gatekeepers and advisors to consider recommending a fund. That makes sense as a part of one's *initial* screening criteria, but the Morningstar study suggests that especially strong three-year performance should not be over-emphasized. It may simply reflect a management style favored by a particular economic environment or phase of the market cycle. Such environments tend to shift.

In view of their findings, Morningstar also looked at asset flows to check investors' inclination to rush into top-quartile three-year performers. That tendency appears to have moderated in recent years, perhaps partly due to greater use of exchange traded funds (ETFs) and other index-based vehicles to fill certain asset categories. Or maybe all the warnings against chasing hot performance are having an effect. ■

Investment Performance Review	**TOTAL RETURN * (dividends and capital gains reinvested)**			
Selected Mutual Fund Categories *	**--- Annualized thru June 7, 2012 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	1.1 %	11.7 %	– 1.1 %	3.9 %
Mid-cap Stocks (Core)	– 4.3	14.3	– 0.1	6.0
Small-cap Stocks (Core) †	– 4.0	13.9	– 0.5	6.3
Foreign Stocks (Multi-cap) †	–16.9	4.9	– 5.4	5.1
Emerging Market Stocks †	–19.1	6.8	– 1.8	11.8
Natural Resources	–12.5	5.6	– 2.8	8.9
Real Estate related	7.0	26.7	0.2	9.6
Flexible Portfolio	– 2.1	9.3	1.3	5.3
General Bond	7.4	9.8	6.1	8.1
Int'l Fixed Income †	– 1.4	7.0	6.5	6.8
High-Yield Taxable Bond †	2.6	13.9	5.3	7.5
General Municipal Debt	11.1	7.9	4.7	4.5

* Source: Lipper, as reported in the *Wall Street Journal*, June 8, 2012. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

HUD Reworks the Reverse Mortgage

We last covered reverse mortgages in late 2006. Home values were peaking, and the prospect of retirees drawing income from the substantial equity in their homes was still rather novel. Six years on many folks' home equity has shrunk, but so have other common sources of retirement income such as CD and bond yields and immediate annuity payouts. Meanwhile the use of reverse mortgages is growing.

A reverse mortgage converts home equity into cash payments to the owner, structured as a lump sum, fixed monthly payments, a line of credit, or some combination. Payments to the homeowner constitute a growing loan against the property. The loan accrues interest, but the debt isn't repaid until the homeowner dies, sells the home, or moves.

Most reverse mortgages are Home Equity Conversion Mortgages (HECMs) insured by the Federal Housing Authority (FHA) under the U.S. Department of Housing and Urban Development. The housing downturn taught the government that insuring home loans carries some risk, so they raised the annual mortgage insurance premium from 0.5% to 1.25% of the home's value.

In late 2010 FHA introduced the HECM "Saver" reverse mortgage which applies a lower cap (by 15%+) on the amount one can borrow while dramatically lowering the up-front mortgage insurance fee from 2% of the home value to just 0.01%. The "Saver" can be advantageous for those who do not need to maximize the amount they can draw and may sell their property within the next few years.

However, if the income gap a senior faces is modest, a reverse mortgage can be a rather costly way to deal with it. Fees for loan origination, appraisals, and processing can run more than 2% of the value of the home, not to mention the annual mortgage insurance charge at 1.25%. Nearly all lenders charge variable interest rates, so a rising rate environment could hasten the build-up of debt against the home.

HUD expected to underwrite 56,000 reverse mortgages in 2006, and Congress that year raised the limit on the number of loans the program *could* insure to 275,000. That limit has not been formally changed, but it has been suspended repeatedly to allow the program to expand.

Applicants for reverse mortgages must first discuss the program with a HUD-approved counseling agency. Another good source of information is the American Association of Retired Persons. Just go to *www.aarp.org* and enter "reverse mortgage" in the Search box. ■

Social Security: Just Some Basic Math

With retirement staring so many Americans in the face, and with yields on conservative fixed-income investments so skinny, strategies for generating a reasonably secure income for life are at a premium. Smart Social Security strategies can make a difference. If you're in that critical age cohort, it's worth taking a careful look at your basic options.

One bit of conventional wisdom is that it pays to delay Social Security benefits at least until your full retirement age, and even to age 70 if you can manage it. Is that always to one's advantage? Let's start with a simple analysis.

For comparison purposes, your flow of future Social Security benefits has a rough present value. It's the amount you'd have to hand over to an insurance company to have it provide that same level of income for life. For example, suppose a 62-year-old man can start receiving Social Security benefits of $1,800 monthly. He would need about $332,000 to buy that basic benefit via an immediate annuity.

If our 62-year-old delays taking Social Security until age 66 (full retirement) his starting benefit will be $2,461 per month (assuming no intervening cost-of-living adjustments). That extra $661 per month sounds good, but what about the $86,400 he could have received in benefits over the prior four years? At current annuity rates, $86,400 (assuming it had been set aside) would only buy our 66-year-old a little over $500 of added monthly income. Waiting on the benefits would appear to have worked out pretty well.

What if our 66-year-old continues to defer Social Security until he's 70? Those benefits would then start at $3,294 per month, $833 more than the benefit starting at 66. The four years of forgone benefits totals $118,128, but at current annuity rates it would cost about $126,000 for a 70-year-old to purchase that extra $833 per month for life.

The above analysis is a simplified but useful starting point. Some factors might nudge the equation the other way. For instance, if one's only alternative to starting benefits is to take significant taxable withdrawals from IRAs or other tax-deferred accounts, starting benefits earlier may make more sense. Poor health or a spouse's benefits picture also could change the calculus. A higher interest-rate environment may raise the value of benefits received and invested, but it might also imply higher cost of living adjustments factored into the larger future benefit levels that go with deferring.

Tax considerations may make deferral the compelling choice. If you start taking benefits before your "full retirement" age, any earned income above $14,640 (2012) triggers a give-back of $1 of Social Security benefits for every $2 earned above that threshold. Even after reaching one's full retirement age, seniors with a reasonably comfortable income may find that Social Security benefits bump their tax bill rather meaningfully at the margin.

Obviously there are enough moving parts here to warrant an individualized analysis with your advisor. **One last note:** Once you turn 70 you might as well start taking your Social Security unless you're trying to single-handedly solve the federal government's fiscal mess. ■

Password-Protecting Yourself Online

Conducting financial business online is pretty convenient, and it *should* be secure. But a lot hinges on the user exercising a little caution and common sense. Take passwords for example.

Surveys and studies indicate that many of us choose passwords that are easy to remember like the names or birthdates of spouses, children, pets, etc. But such passwords can be surprisingly easy for unscrupulous hackers to crack. A recent study by a Cambridge University professor, working with 70,000 anonymous passwords provided by Yahoo!, found that a hacker, given at least 10 tries per account, could likely score the passwords for about 1% (700) of those accounts.

Most financial institutions have added layers of security and more stringent password requirements for clients' online access. They often rule out the use of common words, repeating letters, or number series, while insisting on a mix of letters and numbers, upper and lower case characters, etc. Many sites strictly limit the number of failed log-in attempts before access is disabled.

The importance of security on financial sites is obvious. But you might take the cue for other online subscriptions and services even if they don't directly access financial information. There has been a rise in fraud perpetrated by hackers who gain access to people's e-mail accounts and comb those e-mails to see where the victims hold accounts. Then they pose as the accountholder and e-mail requests to withdraw funds by wire or perpetrate other fraudulent activity. A hacker can probably learn a lot from your e-mail. Try to effectively password-protect that body of information. ■

Breaker! Breaker! Take This Job and ...!

There's a clever couplet you might have seen on the mud flaps of a semi-trailer or two. From left flap to right it reads, "Crime don't pay... Truckin' don't either."

Long-haul trucking is a tough job with modest pay, physical demands, and relatively long stints away from home. When other employment options are plentiful, trucker turnover tends to run relatively high. The American Trucking Association says that annual turnover ranged from 100-120% five or six years ago when unemployment was 5%, then plummeted to 42% by mid-2009.

Despite a rise of about 6% in drivers' wages in recent quarters, trucking company managers say it's gotten tougher to keep their fleets fully staffed. At the same time the Bureau of Labor Statistics reports rising employment in such traditional trucker alternatives as construction and manufacturing. Sounds like an economy slowly on the mend. ■

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