Investor Insights & Outlook

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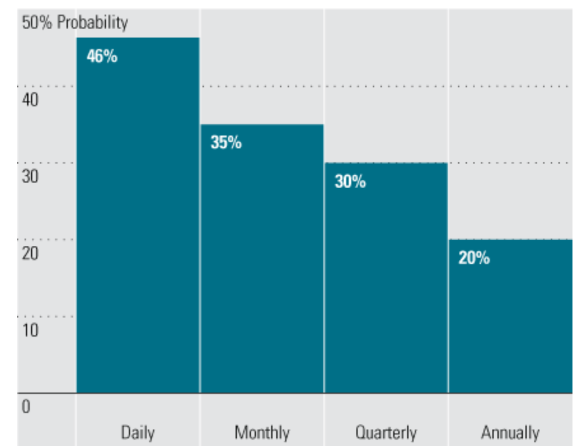
Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

Advisor Corner

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What Is an Economic Moat?

Historical data shows that stocks might be the best investment to help you build wealth over time. However, with so many stocks available out there, how do you decide which one to pick? What makes a stock a good or a bad investment? The answer lies in carefully scrutinizing the company.

A company's stock is likely to generate attractive returns if the company outperforms its competitors. The advantage a company builds over its rivals in the marketplace is called competitive advantage. Morningstar has developed a rating to measure this competitive advantage, the "economic moat." There are four main types of economic moats, examined below.

1. Intangible assets: Intangible assets like brands, patents, and regulatory licenses can provide a company with a unique position in the marketplace and a significant advantage over its competitors. A powerful brand like Apple or Nike can bring in more revenue and increase customer retention. Patents are especially important for technology companies and companies in industries where innovation is critical (pharmaceuticals, for example). Regulatory licenses provide a competitive edge in the sense that they can prevent competitors from entering a market.

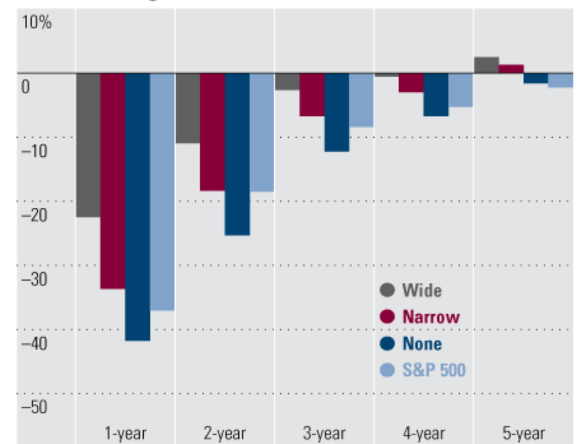
2. High customer switching costs: Basically, if a company makes it difficult (and, ideally, impossible!) for customers to switch to a competitor, that company will have a much easier time growing revenues and expanding. Examples of industries with high switching costs include banks and software companies.

3. The network effect: The network effect is based on the simple premise that the more users a product or service has, the higher its value will be. The most popular example of this type of moat is Microsoft: its success is highly dependent on its enormous user base. In fact, this network effect occurs mainly in businesses based on sharing information and connecting people (eBay is a good example).

4. Cost advantages: This type of competitive advantage is probably the simplest, and yet the most difficult to achieve. Companies can build a cost-based economic moat by improving their business processes (Dell and Southwest Airlines), optimizing their supply chains (Wal-Mart), or by outsourcing in order to reduce labor costs ("made in China," anyone?). Cost-cutting can be a two-edged sword, however, and, once the competitive advantage is achieved, it may prove difficult to maintain.

In Morningstar's database, stocks are assigned an economic moat rating: wide (denoting a strong competitive advantage), narrow (weaker), or none (no competitive advantage). The image shows that wide-moat stocks have outperformed narrow- and no-moat stocks, as well as the S&P 500 index, over the five time periods analyzed.

Total Return by Morningstar Economic Moat Rating, Year-End 2008



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. Returns and principal invested in stocks are not guaranteed. References to specific securities should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell such securities.

Source: Wide-, narrow- and no-moat stocks from Morningstar. The S&P 500® index is an unmanaged group of securities and considered to be representative of the stock market in general.

Are Bonds Adding to Your Equity Exposure?

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

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 ensure a profit or protect against a loss in a declining market.

Tax-friendly States for Retirees

Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a “no sales tax” policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

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