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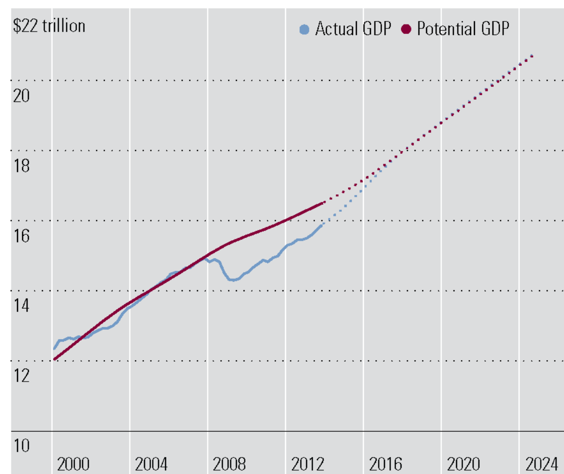
Output Potential Gap Suggests Limited Inflation Risk

Outside of food and drugs, the prospect of high inflation remains dim. The output gap, which compares current and forecasted Gross Domestic Product levels to the estimated potential of the economy, remains at one of its widest levels in history. Every major, sustained bout of inflation in the Post-War era has occurred when the economy has been running above its theoretical capacity. The Congressional Budget Office, the keeper of this key metric, believes that the economy will not operate up to its full capacity until 2017, as shown in the chart. CBO considers unemployment, demographics, capital investment, and productivity, making it a much more comprehensive measure than simpler capacity utilization metrics. Besides the output gap, Morningstar economists believe that monetary and fiscal policy, as well as commodity prices, could also influence inflation levels going forward.

Potential Versus Actual GDP



This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results. Source: Congressional Budget Office.

Advisor Corner

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The S&P 500 set a new all time high on September 18, then volatility began, and on October 15, we were nearing correction territory. Though the broad market did not hit the 10% decline that is needed for a correction, it sure felt like one.

Market volatility is to be expected. It is important during these times to remember why we hold stocks. Since the beginning of 2013, the S&P 500 is up nearly 33%, and the stock market has moved steadily higher over the past five years. Investors need to put the recent market movements into perspective and recall that volatile periods are not only normal, they are healthy.

We aim to ensure that you hold the proper amount of equity in your portfolio before corrections occur, rather than react to them.

If you would like to review your current allocations to make sure they are appropriate for you and your financial goals, please give us a call.

We thank you for your continued business and the trust you have placed with us.

Concerned About Longevity? Three Mistakes to Avoid

Longevity is often cheered as an achievement, but the downside of living well beyond one's average life expectancy is that it can strain (or worse, completely deplete) an individual's financial resources. The first step in addressing longevity risk is to evaluate just how great the odds are that either you or your spouse will have a much longer-than-average life span. Health considerations, family longevity history, employment choices, and income level may all be factors. If you've assessed these considerations and are concerned about longevity risk--or if you've determined that you'd simply rather be safe than sorry--here are three key mistakes to avoid.

Mistake 1: Holding a Too-Conservative Portfolio. When investors think about reducing risk in their portfolios, they often set their sights on curtailing short-term volatility—the risk that their portfolios will lose 10% or even 20% in a given year. But a too-conservative portfolio (one that emphasizes cash and bonds at the expense of stocks) can actually enhance shortfall risk while keeping a lid on short-term volatility. But, right now, interest rates have much more room to move up than they do down, which may reduce the opportunity for bond-price appreciation during the next decade. With such low returns, retirees with too-safe portfolios may not even outearn the inflation rate over time.

Mistake 2: Not Delaying Social Security Filing.* Because it provides an inflation-adjusted income stream for the rest of your life, Social Security is designed to provide you with at least some money coming in the door even if your investment portfolio runs low (or out) during your later years. If you file early (you're eligible to do so as early as age 62), you permanently reduce your annual benefit from the program.

Delayed filing, on the other hand, has the opposite effect, amping up the value of your hedge. Not only will your benefits last as long as you do, but they'll be higher, perhaps even substantially so, as well. Those who delay filing until age 70 may receive an annual benefit that's more than 30% higher than what they would have received had they filed at full retirement age (currently 66) and more than 50% higher than their benefit had they filed at age 62.

Mistake 3: Not Adjusting Withdrawal-Rate Assumptions. Just as savings rates are the main determinant of success during the accumulation years (much more than investment selection, in fact), spending rate is one of the central determinants of retirement plans' viability.

The 4% rule, which indicates that you can withdraw 4% of your total portfolio balance in year 1 of retirement, then annually inflation-adjust that dollar amount to determine each subsequent year's portfolio payout, is a decent starting point in the sustainable withdrawal-rate discussion. But it's important to tweak your withdrawal rate based on your own situation. If you have a sparkling health record and it looks likely that you'll be retired longer than the 30-year withdrawal period that underpins the 4% rule, you may be better off starting a bit lower.

In a similar vein, it's important to not set and forget your retirement-plan variables, such as your spending rate and your asset allocation, because retirement progresses and new information becomes available about your health and potential longevity, market valuations, and so forth.

This is for informational purposes only and should not be construed as legal, tax, or financial planning advice. Please consult a legal, tax, and/or financial professional for advice specific to your individual circumstances. Asset allocation and diversification are methods used to help manage risk. They do not ensure a profit or protect against a loss. Returns and principal invested in securities are not guaranteed, and stocks have been more volatile than bonds.

*Source: Social Security Administration.

To vs. Through

Target-date funds may differ in their investment approach: Target-date funds can be designed to build up savings “to” an individual’s target retirement date, with allocations becoming more conservative at retirement. This approach results in funds adopting higher allocations to fixed income investments at/towards the retirement date, and then a static portfolio thereafter. Contrary to this approach is the principle of “through” retirement funds. Here the target-date fund is designed to help investors through retirement, with the goal of accumulating wealth long after the retirement (target) date. Funds adopting this approach may have higher allocations to stocks at the target date, followed by a declining allocation 10 to 30 years post retirement.

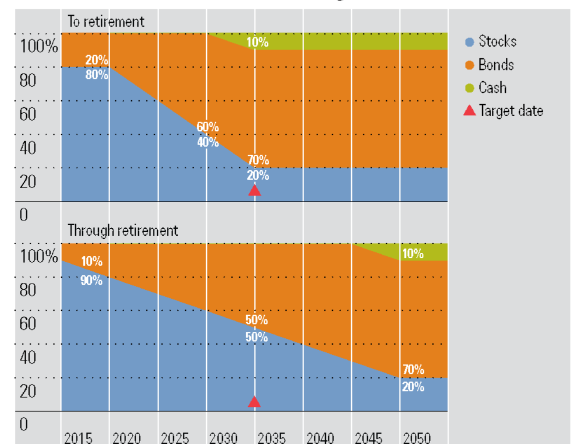
It is important to understand that these two approaches may differ vastly in risk and reward trade-off due to the way the fund invests in stock and bond investments over time.

Choose the strategy that best fits your risk profile: The image above illustrates the difference in allocations to stocks and bonds in both a “to” and “through” approach. Both images display changes in allocation to stocks and bonds over a 40-year period, for example starting in 2011, with a target retirement date of 2031. The “to” approach emphasizes the static glide path while the “through” approach emphasizes a declining glide path.

Retirees face the most risk at the target date, as it marks the start of a period in which savings are needed to fund their retirement. A more aggressive approach (sloping glide path) may improve the chances of preserving retirement savings but is not without the added risk. A conservative approach (static glide path) is designed primarily to build savings. Consult your financial advisor to evaluate a fund that best fits your needs in retirement.

Past performance is no guarantee of future results. Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes only and not indicative of any investment. 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 the other asset classes. The target date is the approximate date when investors plan to start withdrawing assets. The investment objectives of each fund are adjusted over time to become more conservative as the target date approaches. The principal value of the fund(s) is not guaranteed at any time, including at the target date. Investing in target-date funds always involves risk, including the possibility of losing the entire investment. The allocations used in this example are hypothetical and do not represent any particular investment.

Comparison of Hypothetical Target Date Glide Paths in “To” Versus “Through” Funds



A glide path illustrates an investment’s change in target asset allocation along specific time points as an investor approaches, reaches, and settles into retirement. It graphically depicts how the allocation shifts from a more aggressive investment approach to a more conservative one as the investment nears its target maturity date.

An investment in a target-date fund is not guaranteed, and you may experience losses, including losses near, at, or after the target date. There is no guarantee that the fund will provide adequate income at and through retirement. Consider the investment objectives, risks, charges, and expenses of the fund carefully before investing.

Target-date funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money.

Get a Tax-Smart Plan for In-Retirement Withdrawals

The following sequence may make sense for retirees to preserve the tax-saving benefits of tax-sheltered investments for as long as possible.

1) For retirees over age 70 1/2, the first stop for withdrawals are those accounts that carry required minimum distributions, or RMDs, such as Traditional IRAs and company retirement plans such as 401(k)s (to avoid paying penalties).

2) For retirees who are not required to take RMDs or have taken their RMDs and still need cash, turning to taxable assets may be an option. A good start may be selling assets with the highest cost basis first and then moving on to those assets where cost basis is lower (and the tax hit higher). Relative to tax-deferred or tax -free assets, these assets have the highest costs associated with them. However, taxable assets could also be valuable to tap in later retirement years because retirees will pay taxes on withdrawals at their capital gains rate, which is generally lower than the ordinary income tax rate.

3) Finally, after taking RMDs or tapping taxable assets, retirees still in need of cash may want to further tap company retirement-plan accounts and IRAs (Roth IRA assets last.)

401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Direct contributions to a Roth IRA are not tax-deductible but may be withdrawn free of tax at any time. Earnings may be withdrawn tax and penalty free after a 5 year holding period if the age of 59 1/2 (or other qualifying condition) is met. Otherwise, a 10% federal tax penalty may apply. Please consult with a financial or tax professional for advice specific to your situation.

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