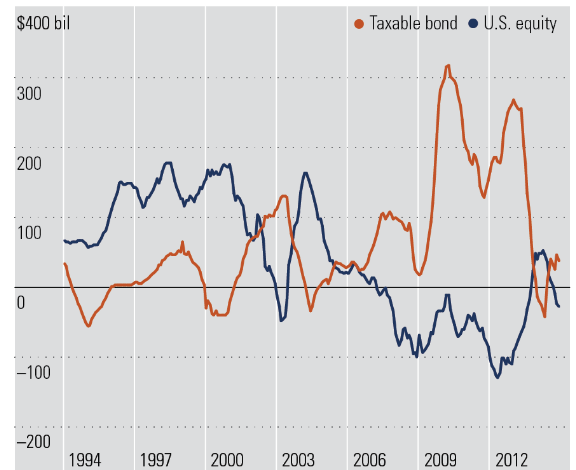
April 2015 | 2nd Quarter | Investment Updates

Bond Versus Equity Fund Flows

Fund-flow data can be a useful for analyzing where investor money is going and how fund-flow trends are correlated with asset-class performance. Between 1994 and 2001, equity flows were higher than bond flows, but all that changed after the dot-com crash when investors started losing confidence in stocks.

The 2007–2009 crisis on the graph illustrates how investor behavior is tied to market performance, even though the timing may not always be right. In 2009, as the stock market hit bottom, investors should have been buying cheap stocks, but instead bond flows increased. In 2012, stock inflows started to climb again. The upswing was short-lived, however, and stock flows have once again been on the decline since April 2014.

Rolling 12-Month Fund Flows



Source: Morningstar Direct. Funds analyzed include U.S. open-end mutual funds. Data as of December 31, 2014.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. *Mutual 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 be read the prospectus and consider this information carefully before investing or sending money.*

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than bonds.

Advisor Corner

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The first quarter brought us $45 barrel oil in mid February, a surging dollar, geopolitical and economic pressures throughout the globe, and seismic market swings in the US. With all of this, the market still hit an all time high in March, before ending the quarter slightly down on the year. What does this mean moving forward?

Volatility is expected to continue throughout 2015. With some additional help from our friends at the Fed, rate changes could add fuel to market swings. History and data have shown us that being "in the market" is far better than trying to "time the market". Dollar cost averaging, as noted inside, is a great way to buy into a roller coaster market. In addition to spreading your market entry over time, having an "all weather" portfolio is an added way to limit down-market impacts and still get invested when the market appears high. Stay true to your long range financial plan and resist the urge to sit on the sidelines or make short-sighted decisions.

Dollar-Cost Averaging: It's Not Just for Stocks

Dollar-cost averaging—the practice of purchasing securities at fixed intervals and in equal amounts over time rather than in one lump sum—has long been used as a way to avoid jumping into the market at the wrong time.

To illustrate how dollar-cost averaging, or DCA, works, consider an investor wishing to buy $10,000 worth of shares of a mutual fund. He could use the lump-sum approach and buy all the shares at once. However, there would be a risk that the market could turn negative shortly thereafter, resulting in an immediate loss on his new investment. Rather than try to determine when the time is right to buy, the investor could ease into the position—for instance, by purchasing $1,000 worth of shares every month for 10 months. That way, if the fund loses value during the time period, less of the investment is exposed to this loss and the investor ends up buying some of the new shares at a lower price than he would have with the lump-sum approach. Of course, if the fund's shares continue to rise, dollar-cost averaging would impose an opportunity cost compared with the lump-sum approach, which, in hindsight, would have produced better results. But, of course, none of us invests in hindsight.

One of the primary benefits of DCA is that it may reduce volatility when buying securities. Rather than risk a purchase price that's too high, DCA allows an investor to buy more shares when prices are low and fewer when they are high during a given time period. It also offers investors a system that avoids the challenge of market timing. Even though DCA may not always result in the highest long-term performance, it may be a good strategy for investors jittery about where the market is headed.

DCA is most often mentioned with regard to stock-related purchases, probably because equity markets tend to be far more volatile than bond markets. However, this approach can be used when buying bonds or bond funds, as well. In fact, given the tapering of the Fed's bond-buying stimulus program and the uncertainty regarding interest rates, which some experts foresee rising some time this year, this might be a good time to use DCA when buying new bonds or bond funds, or if rebalancing a retirement portfolio, to add to existing fixed-income holdings.

One option would be to sell some stock holdings and keep the money in a cash account before dollar-cost averaging into bonds. By putting the money into cash first, equity exposure is reduced in case a market downturn should materialize, and exposure to interest-rate risk is limited by not putting assets all into bonds right away. Instead investors can ease into bonds slowly, so if rates do start to rise and bonds lose value, they can avoid some of those losses while buying more bonds than they would have if they had jumped in with a lump sum.

Given the unpredictable nature of the markets, it's easy to see why DCA appeals to many investors. It can help reduce volatility and the odds of buyer's remorse when investing a lump sum at what turns out to be exactly the wrong time.

Returns and principal invested in stocks are not guaranteed. Investing does not ensure a profitable outcome and always involves risk of loss. Dollar-cost averaging does not ensure a profit or protect against a loss in declining markets. Dollar-cost averaging involves continuous investment regardless of fluctuating prices. Investors should consider their financial ability to continue purchases through periods of high price levels. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual 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.

Misconceptions About Backdoor Roth IRA Conversions

In 2014, the income limit for Roth contributions is $129,000 for single filers and $191,000 for married couples filing jointly. For high-income earners who earn too much to contribute to a Roth IRA directly, the only method of getting new assets into a Roth IRA is to go in through the backdoor, opening traditional nondeductible IRAs, then converting those accounts to Roth IRAs. It's a way for higher-income folks to pay tax now in exchange for tax-free withdrawals of at least some of their assets during retirement. But the maneuver carries some important caveats, so it pays to stay attuned. Here are four of the biggest misconceptions about backdoor Roth IRAs.

Backdoor Roth IRAs Are Always Tax-Free: When you convert the newly opened traditional IRA to a Roth, you'll owe taxes on any appreciation in your shares since you made the initial purchase if you have no other IRA assets. But if you do hold other IRA assets, you'll be affected by what's called the pro rata rule. Under this rule, the IRS looks at your total IRA holdings to determine your tax bill when you do the conversion; the tax you pay depends on your ratio of assets that have already been taxed to those that have not. Let’s say you have $45,000 in a rollover IRA and $5,000 in your new nondeductible IRA. That means your ratio of taxable/tax-free assets in your total IRA is 9/1. Upon conversion of that new $5,000 traditional IRA, you'd owe taxes on $4,500 of income, because 90% of your total IRA pool consists of money that has not been taxed. You'll run into the same issue if you try to execute a backdoor IRA and you also have traditional IRA assets on which you've taken a tax deduction; ditto if you have made nondeductible contributions but a big share of your IRA balance consists of appreciation. In both cases, the pro rata rule would affect the taxes due when you convert.

A Backdoor IRA Should Always Be Off-Limits if You Have Traditional IRA Assets: The preceding example illustrates the tax treatment if you undertake a backdoor IRA and have a lot of money in a traditional or rollover IRA that has never been taxed. If you have a rollover IRA and participate in a company retirement plan that permits it, you can roll that money into the 401(k) before executing the backdoor Roth IRA. In doing so, those dollars wouldn't be part of the calculation of taxes due under the pro rata rule.

Once You Go Backdoor, You Can Readily Make Additional Roth Contributions: One other common misconception about backdoor IRAs is that once you do one, you can make additional Roth contributions. Unfortunately, this is true only if your income falls below the Roth IRA eligibility thresholds in future years, or if you no longer participate in a company retirement plan. If that's the case, you can make a Roth contribution outright. All others, however, will have to go through the same motions to make additional Roth contributions, first contributing to a traditional IRA and then converting to a Roth.

All Roth IRAs Give You Easy Access to Your Cash: Flexibility is one of the key benefits to having a Roth IRA. If you make direct contributions (that is, your entry point into a Roth isn't through converting), you can withdraw your contributions (but not your earnings) at any time without owing tax or a penalty. But if you get into a Roth IRA via conversion, you're governed by a different set of rules. To avoid the 10% penalty on early withdrawals of the amounts you've converted, you need to hold those assets in your Roth IRA for five years, you need to be age 59 1/2, or you need to meet other exceptions.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

Retirement Distribution Pitfalls: Variability in Withdrawals

Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be not allowing for some variability in your withdrawals, based on need. Many retirees use the 4% rule, which holds that you withdraw a specific dollar amount in year 1 of retirement, then adjust that dollar amount upward each year to account for inflation. Even though this rule can provide a good starting point, it's unrealistic to expect that you'll stick with a fixed withdrawal amount every year. You may have years when you need to spend more, such as for a new car, new roof, child's wedding, or a special vacation, and years when you can get by with less.

Workaround: Be sure to pad anticipated expenses a bit to account for extras and unanticipated expenditures. Some retirees, for example, forecast when they would need to replace cars, take big trips, and repair roofs. Those padded expenses should be used when determining whether a withdrawal rate is sustainable. Alternatively, retirees could manage their distributions with the expectations that they will in fact not be static from year to year—for example, paying for unanticipated expenses on an as-needed basis with the expectation that they'll have to tighten their belt in subsequent years.

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