YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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Highlights

- High-quality TIPS have outperformed comparable U.S. Treasury bonds since the July 2016 lows in Treasury yields.
- The high demand for bonds with inflation protection has led to higher prices; yet TIPS' breakeven rates are still below the CPI rate of 2.5%, a modestly favorable condition for TIPS.

Taking the Temperature of TIPS

Breakeven inflation rates still below Consumer Price Index (CPI) levels may present a modestly favorable situation for Treasury Inflation-Protected Securities (TIPS) relative to nominal Treasuries. As of January 31, 2017, U.S. inflation as measured by CPI was 2.5%, higher than the 2.02% 10-year breakeven inflation rate (implied by the differential between the yield on nominal Treasuries and TIPS, as of February 18, 2016). Better economic conditions in the U.S., the potential for fiscal stimulus, and stabilization in the oil and gas markets have increased the likelihood that inflation will continue to rise, fueling investor demand for inflation-protected assets. The increased demand for TIPS has led to price appreciation, making TIPS more expensive. However, with CPI at 2.5%, inflation may continue to climb, possibly making today's price level the new normal. The inflation outlook is uncertain, but for investors concerned about rising inflation, a well-diversified allocation to TIPS may help to minimize inflation risk, while improving the credit quality of bond holdings.

TIPS VS. NOMINAL TREASURIES

Before investing in TIPS, it is important for investors to compare the market's inflation expectation to their own inflation outlook in order to determine relative value. For example, the current 10-year TIPS yield is 0.43%, and the yield on a 10-year Treasury is 2.45%, making the current breakeven inflation expectation rate 2.02%. This is the inflation rate at which an investor would be indifferent to holding TIPS or conventional treasuries. If the investor thinks inflation will average above 2.02% per year for the 10-year period, then TIPS may be a better investment. Conversely, if the average inflation rate is below this breakeven, then the nominal bond would be a better choice. The math behind breakeven analysis is somewhat straightforward. Simply take the U.S. Treasury nominal yield and subtract the TIPS real yield.

Keep in mind that in today's high-price environment, it is not uncommon to see negative yields on certain maturities of TIPS. This occurs when the yield on the U.S. Treasury bond is below the expected inflation rate. Investors should note that a negative yield does not necessarily mean they will receive a negative return, however. The negative yield on TIPS would be offset by the inflation adjustment to the principal value of the bond.

BREAKEVEN RELATIVE VALUE

Deviations between CPI-derived inflation and breakeven inflation rates occur quite frequently [Figure 1]. Generally when the breakeven rate is below CPI, the TIPS investor benefits because the bond's par value rises with inflation as it adjusts to the higher CPI level. When the bond matures, the investor is paid the adjusted principal or original par value, whichever is greater. As seen in the diagram, the periods of 2006, 2008, and 2010, when inflation expectations were quite low, were good times to buy TIPS. In each of the subsequent years (2007, 2009, and 2011), the Barclays TIPS Index outperformed the Barclays Treasury Index, which shows that buying when breakevens are below inflation has been historically beneficial for investors.

Click here for Figure 1: TIPS Tend to Outperform When the Breakeven Rate Is Lower Than Inflation

TIPS PERFORMANCE

The performance of TIPS is highly correlated with the movements in the Treasury bond market; however, TIPS have outperformed Treasuries every month since July 2016, when Treasury yields hit their all-time lows. The rise in nominal yields from the lows was largely due to rising inflation expectations, leading to greater demand for inflation-protected bonds. TIPS have also benefitted from international demand, as low yields overseas have led foreign investors toward the higher relative yields of U.S. bonds.

With January 2017 headline CPI coming in at 2.50% (non-seasonally adjusted), up from 2.07% in the previous month and above the Federal Reserve's (Fed) 2% target, TIPS are potentially situated to perform well. Oil and gas prices (key components of CPI) have stabilized and could lead to even higher headline CPI readings over the balance of the year. This should benefit TIPS owners, but if headline inflation isn't able to continue exceeding implied breakevens, the benefit will be muted.

Our base case remains that Treasuries are likely to stay in their current 2.25-2.75% range through year-end 2017, with a gradual move to higher yields over the longer term. Interest rates could take another turn lower (which would benefit Treasuries and TIPS) due to either market volatility or surprise central bank moves (foreign or domestic). However, a range-bound interest rate environment would mean yields (plus the inflation adjustment to principal for TIPS) will become a bigger driver of total returns for bonds, making TIPS and Treasuries less attractive than other areas of the bond market, such as investment-grade corporates, mortgage-backed securities (MBS), or lower-quality fixed income options.

RISKS

Despite their advantage as an inflation hedge and a diversifier, TIPS are not risk-free. The CPI index used to calculate the principal adjustment is non-seasonally adjusted, which can be volatile on a monthly basis. Additionally, oil is an important component of CPI, both explicitly and in its impact on other prices like food, so the inflation adjustment will largely track movements in this market relative to other inputs, which are usually more stable [Figure 2]. Strong performance for oil, either positive or negative, could have a large impact on TIPS returns.

Click here for Figure 2: Oil Is a Strong Driver of TIPS Performance

Investors in TIPS are also subject to ordinary income tax based on yearly income, even though the investor won't receive the additional principal until the bond matures. This impacts direct buyers of individual TIPS bonds but can be avoided with a mutual fund, as principal adjustments are usually distributed monthly by the fund.

CONCLUSION

For investors concerned about inflation, TIPS offer protection if inflation should rise, and include a guarantee that the par value is protected, backed by the U.S. government. With the Fed on schedule to raise rates two to three times in 2017, and recent consumer price data coming in higher than expected, an allocation to TIPS may provide clients with more diversified fixed income exposure and help reduce portfolio volatility. Investors need to understand that TIPS are not perfectly correlated to changes in inflation and are particularly susceptible to underperformance in volatile markets. Also, TIPS are currently low yielding (priced high), but breakevens below CPI have historically signaled value relative to nominal Treasuries. We continue to remain neutral on TIPS due to the higher prices acting as a potential headwind on returns, but we are constructive on the high-quality nature of the asset class as the economic cycle continues to age.

INDEX DEFINITIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

RES 5802 0217 | Tracking #1-583735 (Exp. 02/18)

When Planning, Focus More on Goals, Less on Numbers

Values have a significant role to play in determining how individuals manage their assets.

Financial planning is a complex, lifelong process that people tend to approach with a numbers orientation. What rate of return do I need to reach my goal? How much insurance do I need? Can I afford a bigger house? How much money do I need to save for retirement?

To support their pursuit of the "right numbers," people often use separate advisors -- for instance, a banker, a financial planner, an insurance agent, a tax professional, and an estate planning attorney -- to oversee the various components of their household wealth. But can too many cooks spoil the broth?

This "siloed" approach to financial planning can easily lead to redundant investment strategies that could create exposure to unnecessary levels of risk. It may also result in multiple, random investment accounts in need of consolidation. Furthermore, such an approach may inadvertently overlook crucial tools, leaving entire planning areas to chance.

Unlocking Financial Synergies

When viewing their financial goals -- such as buying a home, paying for a child's education, or saving for retirement -- individuals typically think in terms of what those goals cost rather than how achieving them might affect their lives. If, however, they were to reengineer the planning process and assess their current life issues and future aspirations prior to selecting investments and asset allocation strategies, they may be in a better position to achieve satisfactory outcomes. Perhaps equally important, by putting life circumstances at the center of financial decision-making, individuals may find more meaning in their actions with regard to money.

Indeed, values have a significant role to play in determining how individuals manage their assets. This is one way in which a holistic approach to "financial life planning" enables individuals to better assess their wants and needs, establish meaningful priorities, and avoid misguided investments. And, as life circumstances and priorities change -- as they inevitably will -- so too do financial goals. In this way, individuals employing a holistic approach to planning can easily identify and address those areas of their financial lives that are still working well and those that may be hindering their financial well-being.

Crafting a Plan

Crafting a plan that reflects your unique situation and that ties your life aspirations to your financial goals is part art, part science. To achieve this level of planning you need to rely on the guidance of a single skilled advisor -- someone who will take the time to get to know you and your circumstances and who will put together an appropriate combination of vehicles, strategies and, where appropriate, additional planning professionals to help achieve your goals -- whatever they may be.

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Dividend payouts are often seen as a sign of a company's financial health and management's confidence in future cash flow.

In Volatile Markets, Investors May Find Comfort in Dividends

As uncertainty at home and abroad roils the financial markets, income-minded investors seeking protection from the bumpy road ahead may find dividend-paying stocks offer an attractive mix of features and warrant a place in their equity portfolios.

The appeal is simple: Dividend-paying stocks can provide investors with tangible returns on a regular basis regardless of market conditions.

The Benefits of Dividend-Paying Stocks

If you own stock in a company that has announced it will be issuing a dividend, or if you are proactively considering adding an allocation to dividend-paying stocks, history provides compelling evidence of the long-term benefits of dividends and their reinvestment.

- **A sign of corporate financial health.** Dividend payouts are often seen as a sign of a company's financial health and management's confidence in future cash flow. Dividends also communicate a positive message to investors who perceive a long-term dividend as a sign of corporate maturity and strength.
- **A key driver of total return.** There are several factors that may contribute to the superior total return of dividend-paying stocks over the long term. One of them is dividend reinvestment. The longer the period in which dividends are reinvested, the greater the spread between price return and dividend reinvested total return.
- **Potentially stronger returns, lower volatility.** Dividends may help to mitigate portfolio losses when stock prices decline, and over long time horizons, stocks with a history of increasing their dividend each year have also produced higher returns with considerably less risk than non-dividend-paying stocks. For instance, over the past 10 years, the S&P 500 Dividend Aristocrats -- those stocks within the S&P 500 that have increased their dividends each year for the past 25 years -- produced annualized returns of 10.25% vs. 7.31% for the S&P 500 overall, with less volatility (13.99% vs. 15.06%, respectively).[1]

The Growth of Dividend-Paying Stocks, 1986-2015[2]

If you are considering adding dividend-paying stocks to your investment mix, keep the following thoughts in mind.

- **Dividend-paying stocks may help diversify an income-generating portfolio.** Income-oriented investors may want to diversify potential sources of income within their portfolios. Given current realities present in the bond market, stocks with above-average dividend yields may compare favorably with bonds and may act as a buffer should conditions turn negative within the bond market.
- **Dividends benefit from continued favorable tax treatment.** The extension of the Bush-era tax cuts helps to reinforce the current case for dividend stocks. The tax bill that passed in early 2013 made the 15% top tax rate on qualifying dividends and other forms of investment income permanent for most investors, though it did raise the top rate to 20% for certain high-income investors. However, this is still lower than the 39.6% top rate on ordinary income.

Note that dividends can be increased, decreased, and/or eliminated at any time without prior notice.

[1]*Return and standard deviation cover the 10 year period ended December 31, 2015. Volatility is measured by standard deviation. Past performance is no guarantee of future results.*

[2]*Source: ChartSource®, DST Systems, Inc. For the period from January 1, 1986, through December 31, 2015. Stocks are represented by the S&P 500 index. Stock prices are represented by the change in price of the S&P 500 index. It is not possible to invest directly in an index. Past performance is not a guarantee of future results. Copyright © 2016, DST Systems, Inc. All rights reserved. Not responsible for any errors or omissions.(CS000029)*

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Options for Inherited Assets From an Employer-Sponsored Retirement Plan

If your spouse had already begun taking RMDs, you must continue to take them at least at the same rate.

If you recently inherited retirement assets from a deceased loved one, it is important to pay attention to IRS rules that govern this type of bequest. Your options in managing this money typically depend on your relationship to the deceased and whether he or she had already begun taking required minimum distributions (RMDs) upon reaching age 70½.

Considerations for Spouses

Spouses have three options when it comes to inheriting assets from a qualified defined contribution retirement plan:

- Keep it in the plan.
- Take the assets as a lump sum.
- Transfer the assets into their own IRA.

As long as your spouse's plan permits, you may keep the assets in the plan as a "beneficiary account" and continue to enjoy its tax-deferred status. If your spouse had already begun taking RMDs, you must continue to take them at least at the same rate. If your spouse had not yet begun taking RMDs, you can delay taking them until the year your spouse would have turned age 70½.

If you take a lump-sum distribution, you will be required to pay income taxes on the full amount. Twenty percent of the amount due to you will be withheld automatically.

If you transfer the assets into an IRA, you are not required to pay federal estate or income taxes if the assets are left intact within the estate. After reaching age 70½, you must begin RMDs based on your life expectancy. If you have already begun taking RMDs, you must take your distribution for the year before transferring the assets into your account.

Considerations for Non-spouses

Non-spouses also have three options:

- Keep it in the plan.
- Take the assets as a lump sum.
- Roll over the assets into an inherited IRA.

Your option to keep it in the plan is dependent on plan guidelines: Some will allow you to keep the account in the plan; some will require you to withdraw the assets. If the deceased had already begun taking RMDs, you must continue taking them at the same rate or faster. If the deceased had not yet begun taking RMDs, you must begin taking distributions by the end of the year after the person died.

As with the spousal scenario, taking a lump-sum distribution will necessitate the payment of income taxes on the full amount. Twenty percent of the amount due to you will be withheld automatically.

If you are opening an inherited IRA, the account must be held in the name of the original participant, with you listed as the beneficiary. You will be taxed on your distributions as you take them.

Considerations for Trusts

For estate planning reasons, sometimes the deceased designated a trust, not an individual, as the beneficiary. Often it is assumed without detailed analysis that because the beneficiary was a trust, the money must be withdrawn immediately. However, each trust document is different. In certain situations, you may be able to treat the inherited account as though you were the named beneficiary. In other situations, you may have no choice but to close the account immediately. Before you act, you should have a professional specializing in this area review the trust document and help you understand your options.

Because determining the tax status of inherited retirement assets can be complicated, you may want to consult an estate planning attorney, tax professional, or a financial advisor to answer any questions you may have.

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Choosing a Cause With Care

For many nonprofits, the best way to evaluate their operations is to simply ask representatives about their mission, programs, financials, and board of trustees.

Prospective donors can find a suitable charity just about anywhere they look. However by doing some homework, you can better distinguish among the many giving opportunities available to you.

What Makes a Charity a Charity?

Generally, a charity is a tax-exempt organization that can receive tax-deductible contributions. To be recognized as a charity, most organizations must file an application with the IRS. Once approved, the IRS generally issues a determination letter confirming that the organization is tax exempt and that contributions to it are tax deductible for federal income tax purposes.

Mission Critical

While the IRS designation recognizes an organization's intent to operate in the best interest of a cause, it does not evaluate the effectiveness with which the organization pursues its mission. To be successful, a charity needs:

- A mission statement/strategic plan: Does the organization's mission statement clearly state whom or what it serves and what it hopes to achieve -- and how it will execute its plan?
- Financial statement/Form 990: This form provides a financial snapshot of the charity's fiscal strength. The IRS requires most tax-exempt organizations to file a Form 990 annually, although there are many exceptions. Individuals can request copies of a charity's Form 990 directly from the charity or view them online at Foundation Center and other websites.
- Board of Trustees: The board oversees an organization's financial and legal responsibilities, manages its executives, and guides the vision that promotes the organization's cause.

Choose Carefully

While independent groups such as the BBB Wise Giving Alliance and GuideStar provide helpful information, it is ultimately up to you to judge whether a particular charity matches your giving objectives. Before choosing a charity, consider the organization's programs and whether they reflect its stated mission. Request copies of the organization's financial documents, including its annual report and a list of its board members. These should provide a clear view of the charity's operations and its management team. Also, spend some time browsing the charity's website to learn more about its activities, capital campaigns, and other unique features.

Most importantly -- Ask questions! For many nonprofits, the best way to evaluate their operations is to simply ask representatives about their mission, programs, financials, and board of trustees.

In charitable giving, information is critical. By taking time to research your choices, you can rest assured that your generosity will be put to good use.

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