QUICK MARKET UPDATE

Growth of Income

Scott Rawlins, CFP®, Manager – National Sales
Jaco Jordaan, CFA®, CFP®, ChFC®, Senior Portfolio Manager

We are living longer than our parents. They lived longer than their parents. Their parents lived longer….you get the picture. We are all faced with the proposition of a longer life expectancy. However, the longer life expectancy comes with a price…literally. The price is the cost, in dollars, of living through retirement. A longer life expectancy means you will likely need more money to fund your retirement, and that requires careful planning. In short, it is likely that your retirement income will have to last longer than it did for your grandparents, and it will have to grow over time to keep pace with the cost of living.

Conventional wisdom for income in retirement is to simply shift the allocation of investments from stocks to bonds to reflect a change in goals from growth to income. In this scenario, investors shift from stocks to bonds for two reasons. First, because bonds are perceived to be a more stable source of income than stocks, and second, because bonds are perceived as less vulnerable to price declines than stocks. We believe investors may be overestimating the stability of principal and income in bonds, and underestimating the income generating capabilities of stocks.

To make our case, we will examine three risk factors (two of which are closely related and will be discussed together) to evaluate the risk of loss in bonds and the need to grow income over time.

Interest Rate Risk

What is interest rate risk? A simple definition of interest rate risk is that when interest rates rise, the value of the underlying bond falls. Similarly, if interest rates fall, the value of the underlying bond increases. Said another way, there is an inverse relationship between rates and bond prices.

For most of the last 30 years, interest rates have generally been trending down. As a result, investors have generally experienced increased bond prices and have become complacent about interest rate risk. Now, with interest rates at historic lows, an increase in interest rates becomes a highly probable event, and it is important to once again become aware of the risk this poses for bond portfolios.

How much will the value of a bond change if interest rates move? To answer this question, bond investors look at a measure of interest rate sensitivity called "Duration." This measure estimates the change in a bond's market price for a 1% change in interest rates.

Let's look at an example: The most common rate that is quoted in the bond markets is the rate on the 10 year U.S. Treasury bond. The current 10 year Treasury rate is approximately 2%. That means if an investor buys the 10 year bond today, they can expect to receive a payment of 2% every year if they hold the bond to maturity. The market value of the bond is based on current interest rates in the market. When those rates move, the value of the bond will change. The current duration of the 10 year U.S. Treasury is approximately 9. That means if interest rates rise 1%, we should expect the price of the bond to FALL by 9% (1% x 9 = 9%). A 2% rise in rates would result in a fall by approximately 18%, and a 3% rise would result in a 27% decline in bond value.

Is a rise in rates likely? And if so, when and by how much? Unfortunately, these questions are impossible to answer. However, we can look at historical rates for some guidance. The 10 year Treasury bond was yielding approximately 5% as recently as June 2007. It would take a 3% rise in interest rates to get to that level (think 27% decline in 10 year bond value). Within the last decade, the highest the 10 year rate has been is approximately 6.67%. A return to that interest rate level implies a 42% decline in the value of the 10 year Treasury.

Currently, the Federal Reserve is focused on keeping interest rates low in an attempt to fuel the sputtering economic recovery. If they are successful, this monetary stimulus will unwind, and currently artificially low interest rates will be allowed to float, and may increase. We believe most investors will likely be surprised by the magnitude of these estimated losses in their bond portfolios should this happen, and should be cause for concern.

Longevity Risk and Purchasing Power Risk

What is longevity risk and purchasing power risk? Longevity risk is the risk that we live longer than we planned for, and as a result, we run out of money. In other words, we outlive our retirement savings. A related risk is purchasing power risk, which is the risk that inflation systematically erodes the value of our retirement nest egg, and we end up unable to keep up with the cost of living as the years tick by. Both of these risks require that we consider investing in assets that may be able to grow our retirement savings, and grow the income that we can draw from our retirement savings to keep up with the pace of inflation.

What do you need to know to prepare for these risks in the future? The Bureau of Labor Statistics provides us with a measure of inflation called the Consumer Price Index (CPI). Since the mid-1980s, the CPI has been remarkably stable when measured over several years. It has, however, been consistently positive.

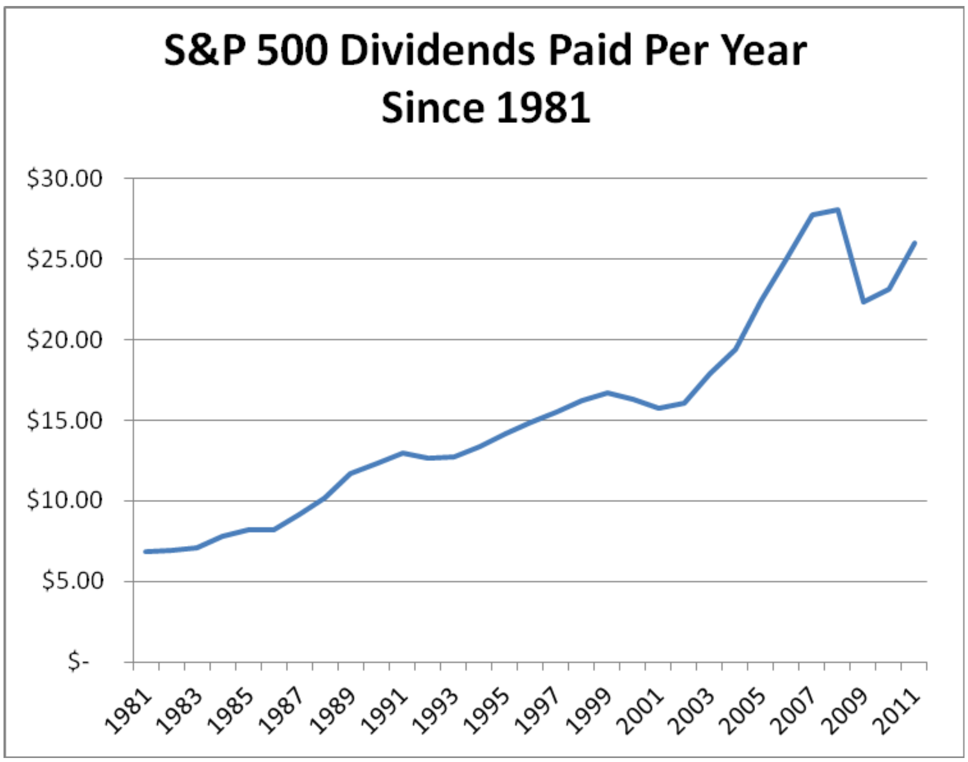
Right now, the 10 year historical average CPI is a hair under 2.5%. That sounds like a low number, but consider the following example. If I leave a dollar under my mattress, just a 2.5% inflationary rate would reduce the purchasing power of that same dollar to $0.77 in 10 years. Said another way, something you can buy today for one dollar will cost approximately $1.28 in 10 years.

If you are not planning to grow your income over time, you may have to make some difficult decisions on which goods and services to do without 10, 20, or 30 years from now.

The Equity Income Option

As stated at the beginning, conventional wisdom views stocks as a way to grow principle over time, and bonds as the best way to generate income. In general, investors do not think of stocks as a source of income. We believe if investors change their risk frame of reference to focus on interest rate risk, longevity risk, and purchasing power risk, bonds become less attractive. As an alternative, investors should consider more carefully the income characteristics of stocks – specifically their ability to grow income through dividends over time.

The chart below displays the dollars paid in dividends from the components of the S&P 500 over the last 30 years. Why look at 30 years? Because that is the current joint-life expectancy of a 65 year old couple.



Bloomberg

Notice the trend is upwards. An investment in the S&P 500 has provided growth not just of principal, but *growth of income* as well. Following the market downturn in 2008-early 2009, many companies slashed dividends in order to preserve their balance sheets. However, notice that as we have emerged into a recovery, dividends have resumed their upward trend.

The S&P 500 index is an index of 500 major U.S. large cap corporation.

An investment cannot be made directly into an index.

How do stocks grow income over time? Dividends are paid out of a company's earnings. Without positive earnings it is impossible for a company to share profits with its investors (a company cannot pay out losses). The percentage of earnings that is paid out as a dividend is known as the payout ratio. There are two ways the payout ratio can impact growth of income.

First, if a company decides to increase their payout ratio, income will increase assuming that earnings remain at the same level. In 2011, the dividend payout ratio for the S&P 500 was approximately 27%. That is below the 30 year historical average of 42%, implying that there may be room for the payout ratio to increase in the future.

Second, even if a company does not increase their payout ratio, if it can grow earnings, the same payout ratio applied to higher earnings results in a larger dividend payment. In fact, this is the main mechanism by which stocks have grown income over time – the growth of income shown on the chart on the previous page is a due to economic growth which results in increasing earnings and higher aggregate dividends over time.

Finding the Right Mix

When most people think about investment risk they generally think of it as the risk of principal loss from stocks. This article hopefully introduces the idea that risk has more dimensions than short term market fluctuation of stocks. Fixed income is subject to short term market swings if interest rates rise, and investors' retirement plans are subject to longevity and purchasing power risk.

What to do about it depends on your unique circumstance, assets, spending patterns, etc. Using equities to generate income may not be an appropriate strategy for all investors. For many, it should be considered as part of a diversified portfolio of stocks, bonds, and real assets designed with each investor's personal goals in mind. To determine what may be appropriate for you, we suggest contacting your H.D. Vest Advisor to discuss your personal goals and objectives.

Source:

All data throughout this article is sourced from Bloomberg.

Disclosures:

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