Mitchell McLeod Pugh & Williams
Investment Adviser

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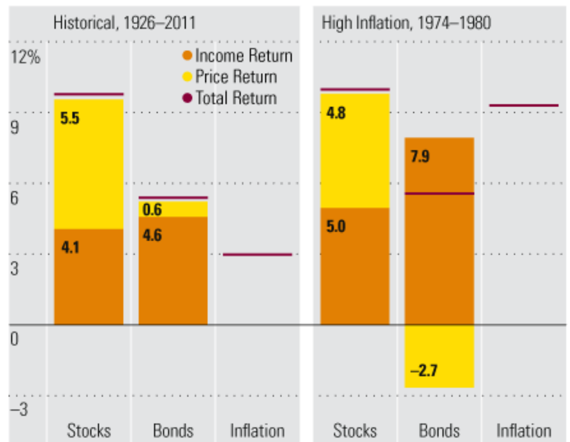
Dividends and Inflation

As an investor, you may ask if an allocation to dividend stocks in your retirement portfolio will help keep up with inflation. Examining stock returns during periods of high inflation may answer this question. Dividend-paying stocks may offer benefits such as stability through income return and inflation protection. While stock prices tend to be volatile, dividends may serve as a stable component of total return and may provide better inflation protection compared with bonds. Between 1974 and 1980 (high inflation period), the average rate of inflation was 9.3%, much higher than the historical rate of 3%. During this time, bonds yielded 7.9% from income, but prices declined by 2.7%, resulting in a total return of 5.6%—way short of inflation. On the contrary, stocks returned a total of 10%: 5.0% from dividend income and 4.8% from price return, outpacing inflation for this time period.

Performance of Stocks and Bonds Relative to Inflation



The 1974–1980 time period was chosen as representative of high inflation because it contains multiple consecutive years when inflation was 5% of higher (except 1976). The sum of the price return and income return may not equal the total return due to compounding. Past performance is no guarantee of future results. Dividends are not guaranteed. Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 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. Stocks are represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 5-year U.S. government bond and inflation by the Consumer Price Index.

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Diversification across multiple regions, asset classes, capitalization ranges, and industries is a cornerstone of our investment philosophy and has served our clients well. The very nature of not "putting all your eggs in one basket" means having exposure to various areas of the market. This long term strategy, however, can mean short term periods of pain. Diversified portfolios that include international investments have experienced some of this pain over the last twelve months. With roughly half of the developed stock market opportunities existing outside of the U.S., investing in foreign assets is a prudent element of diversification. As of 6/30, twelve month returns for the MSCI EAFE index, however, show a 13.8% decline versus a 5.5% gain for the S&P500. This dislocation has occurred after international investments outperformed the S&P500 in three of the last five calendar years. In the short term, returns of different asset classes will vary. In the long term, diversification helps investors reach their investment goals.

Monthly Market Commentary

Investors continued to monitor the situation in Europe, as news on Spanish financials moved markets both down (poor Spanish bank audits) and up (support loans for Spanish banks). Up to this point, there is still no long-term remedy for European countries, with the expectation that they will continue to struggle over the next several years under austerity programs, diminished growth prospects, and waning confidence.

While economic data in the U.S. were generally weak, they were not weak enough to drive the Federal Reserve to introduce a new program. Instead, the Fed merely extended Operation Twist until at least late 2014. Morningstar economists doubt that the program will have much more than a symbolic effect on rates, given the already-low rates on long-term securities.

Employment: June saw a disappointing 84,000 jobs being added, mostly from sluggish private sector job gains. While the economy actually added 815,000 jobs, 731,000 were subtracted because of the seasonal adjustment factor. The good news is that in July, the seasonal adjustment factor will add, instead of subtract, more than 100,000 jobs to the total number, so that's something to look forward to. The unemployment rate remained at 8.2%.

Manufacturing: Manufacturing data in June fell sharply, mainly from a massive drop in new orders. This was the largest month-to-month decline since October 2001, and reversed 37 straight months of positive growth readings. Morningstar economists believe that many firms, faced with economic uncertainty in both developed and emerging economies, may have held back on new orders. However, at this stage of the recovery, the U.S. economy can tolerate some weakness in the manufacturing sector since it only represents 11% of overall employment. Month-to-month durable goods orders jumped 1.1%, but this was not enough to offset several previous months of decline. On a year-over-year basis, growth has slowed materially, falling to 4.6% from 6.9% in the prior month.

Auto: Auto sales have been a key driver in the economic recovery, and while they exploded upward in the beginning of the year because of favorable weather conditions, growth has tapered off from March through May. Fortunately, auto sales in June jumped back up to 14 million units from 13.7 million in May, which was 21% above last year's tsunami-blighted numbers, putting a stop to the downward trend.

Housing: Housing data in June have been highly optimistic, with uniformly positive pricing data, new home constructions trending upwards, existing home sales data driven up at least partially by a lack of quality inventory, and homebuilder-related financial data continuing to rise. Morningstar economists believe that the more predictive, earlier-in-the-cycle data is stronger than the more concurrent data, indicating more gains ahead. Furthermore, low rates, falling inventories, and higher sales levels should lead to better pricing results as well.

Quarter-end insights: It has become more clear that the U.S. is less dependent on exports than many other countries (U.S. exports represented only 13% of GDP according to 2010 data), and so a general slowing of the world economy would not drastically affect the U.S. economy. However, the U.S. economy is not the same as U.S. stocks, so S&P 500 companies that have substantial overseas exposure are still at risk. Stocks with lower overseas exposure, such as utilities, communications, and health-care stocks, were among the best performers in the second quarter. The relative U.S. strength showed up in country-level data as well, with U.S. indexes down only 5% near the end of the second quarter, while both European and emerging-market indexes were down 10-15% for the quarter. Overall, consumers continued to spend, fueled partially by falling gasoline prices. Unfortunately, low commodity prices were bad news for many basic material companies, as prices for their goods dropped while costs of production remained relatively high.

How to Cope with Financial Anxiety

No one likes uncertainty. We want to maintain at least the illusion of control. But that's almost impossible to do today, given the volatility of the stock market and employers' belt-tightening. Even the steadiest hand is shaking just a little. It is imperative to avoid letting your emotions get in the way of making smart investment decisions. In times of doubt, it might be in your best interest to follow these steps for re-examining your current financial strategy.

Reassess Your Risk Tolerance: Today's investor is living those “hypothetical” questions that appear on risk-tolerance questionnaires. If you haven't checked your risk tolerance (the degree of uncertainty that you can handle in your investment portfolio) in more than a year, you're most likely due—especially if you're uncomfortable right now. Maybe you've taken on more risk than is prudent. If so, it might be in your best interest to change your asset mix. If you find that you're taking on the appropriate amount of risk for your goals, just sit tight.

If You Have to Do Something, Review Your Expenses: When dealing with uncertainty, some people feel compelled to act. Instead of trying to time the market (which even the professionals can't do with any consistency), focus on things you can control with certainty: expenses. Identify where you can tighten your belt. Try to identify unneeded or underused services. After such cuts, you’ll have some extra cash to invest each month. Expenses also matter in investment accounts. Do you know what you’re paying in expense ratios, 12b-1 fees, front- or back-end loads? Burn up some of your nervous energy by making sure those expenses aren’t eating up what little positive returns you might have.

Create a Shopping List of Investments: Research stocks or funds that would complement your portfolio, then see where they are currently trading. This could be a great opportunity to pick up some of your favorite picks at rock-bottom prices. However, make sure they are trading at historical lows because of investor overreaction and not because they are no longer financially sound.

Win the Psychological Battle: Don't let the financial media scare you into making poor investment decisions. Times of great uncertainty are usually bad times to be making major decisions. What is healthy is knowing how the human mind works and factoring that into your investment decision-making process. Researchers and academics in the field of behavioral finance attempt to better understand and explain how emotions and perceptions influence investors and their decisions. If you are interested in learning more, there are plenty of publications devoted to this relatively new field.

Consider all of the complex financial decisions faced by investors today. Without experience in different market environments or knowledge of market history, how might investors make such decisions? Potentially through their perceptions or based on their emotions. Thus, it is imperative that investors understand and combat the myriad of illusions to which they might be prone.

When the markets are doing well, people tend to think the trend will continue indefinitely. During the recent crisis when the market was struggling, we witnessed overreaction: Investors were running away from the stock market. However, if you think U.S. companies are still fundamentally strong and will profit in the next five to 10 years, then you should still have a stake in the stock market. Just make sure you set your asset allocation policy first, and then stay the course with an appropriate mix of stocks, bonds, and cash. Investing is a long-term proposition—don’t let your emotions overpower your sense of reason.

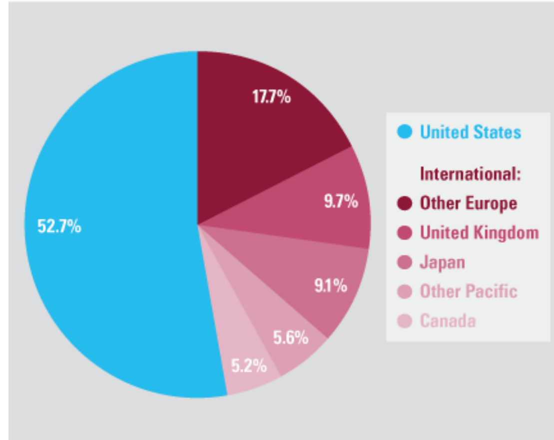
Stocks are not guaranteed and have been more volatile than bonds. Past performance is no guarantee of future results. Diversification does not eliminate the risk of experiencing investment losses.

A World of Opportunity

As trade barriers continue to break down, the world economy has become a small neighborhood. Should investors seek to participate in this wave of globalization, or are they getting all they need here at home?

Historically, foreign investments have acted in a significantly different way from domestic investments. When the U.S. market slumped, various opportunities abroad have prospered. An American investor who put some money into foreign markets may have reduced risk while still attaining attractive returns. With the spread of globalization, this benefit decreases as companies across the globe are acting more like each other. However, as the image illustrates, an investor who doesn't take advantage of options outside of the United States is missing out on roughly half of the investable developed stock market opportunities in the world.

World Stock Market Capitalization
Year-End 2011



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Source: World Market Capitalization by Country is from the Morgan Stanley Capital International Blue Book℠. The data is expressed in U.S. dollars.

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