MITCHELL MCLEOD PUGH & WILLIAMS
INVESTMENT ADVISER

July 2013 | Volume 29 | Quarterly Newsletter

Understanding Risk Tolerance and Risk Capacity

When determining an appropriate asset allocation mix, it is important to consider not only one's risk tolerance, but also one's risk capacity.

An investor's risk tolerance refers to his or her aversion to risk, while an investor's risk capacity relates to his or her ability to assume risk. Sometimes, an investor's risk capacity and risk tolerance do not match up. If an investor's capacity to take risk is low but the risk tolerance is high, then the portfolio should be reallocated more conservatively to prevent taking unnecessary risk. On the other hand, if an investor's risk capacity is high but the risk tolerance is low, reallocating the portfolio more aggressively may be necessary to meet future return goals. In either case, speaking with a financial advisor may help to determine if your risk tolerance and risk capacity are in sync.

Risk Strategy Matrix

		Risk Capacity	
		High	**Low**
Risk Tolerance	**High**	No action required	Consider reallocating more conservatively
	Low	Consider reallocating more aggressively	No action required

There is no guarantee that diversification or asset allocation will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. It is highly recommended that you consult with a financial professional for advice specific to your situation.

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MORNINGSTAR

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Mitchell McLeod Pugh & Williams, Inc. - Bond Market Dislocation

Bond returns were negative for the second quarter. Fixed income values fell as interest rates rose in response to remarks by Federal Reserve Chairman, Ben Bernanke, regarding a possible end date for the Fed's program of Quantitative Easing. This program has helped push interest rates to record lows. Investors, fearing higher interest rates and a decline in bond values, pulled as much as $60 billion from bond mutual funds in June. Conventional wisdom is that interest rates will continue to rise, pushing bond values down even further. Investors are wondering whether they should reduce or eliminate their bond holdings altogether. To do so at this point is essentially timing the market. In fact, many bond analysts feel that rates have peaked for the near term and may actually decline again in the second half of the year. Bonds are an important asset class providing stability and income – offsetting more volatile stock investments. Perhaps a more important consideration is the role that bonds play in investors' long-term asset allocation.

Monthly Market Commentary

The markets went through a lot of turmoil in June, as stronger economic reports were offset by fears of the Fed tapering its bond-buying programs. Home prices, employment reports, and auto sales were all better than expected, unlike trade and GDP data. Together with falling business investment and government employment, that leaves the consumer and housing as the two main engines of economic growth.

Federal Reserve news: Fed statements and a news conference suggested that the economy was stronger than it previously thought, and, as a direct result, bond purchases could be cut back as early as this year and eliminated as early as the middle of 2014, if the economy tracks Fed forecasts and the unemployment rate is around 7%. This, combined with a solid employment report, caused a significant increase in mortgage rates the Friday after Independence Day. For example, 30-year fixed rates climbed into 4.75% territory, with some lenders at 4.875% (according to Mortgage News Daily).

GDP: The third and final revision of first-quarter GDP growth revealed a lower-than-expected 1.8%. The Fed's outlook for the economy has been remarkably bullish, with forecasted GDP growth for 2013 of 2.3%–2.5%—a little too high, in light of the weak first quarter.

Employment: The June employment report showed growth of 195,000 jobs, similar to the previous three months when all revisions are considered. This number was better than the 12-month average and the consensus estimate of about 160,000 jobs. Year-over-year three-month average data has remained virtually stagnant in the 1.9%–2.1% range for almost a year (2.0% for June). However, the mix of jobs added wasn't great. The leading categories were leisure/entertainment and retail; manufacturing and government were down. In other words, jobs considered to be higher-quality and better-paying were down, while lower-paying jobs showed most of the growth. Also, health care and education, normally strong sectors, showed about half of their normal growth. The unemployment rate remained unchanged at 7.6%.

Housing: Reported CoreLogic data for May showed that prices increased 12.2% compared with May a year ago, the biggest percentage increase since 2006. This also marks the 15th consecutive monthly increase in prices. These price increases (along with falling gasoline prices) may be behind the jumps in consumer confidence and consumer spending that exceeds income gains. Even higher mortgage rates are not likely to quell recent price movement by much. In fact, attempts to beat the mortgage-rate increases may be driving some of the real estate activity.

Consumer spending: The personal consumption report showed that spending was locked in its same tight range, with income growth improving but trailing way behind spending growth. Regrettably, income growth is likely to keep a lid on consumption growth, which in turn will keep GDP in check.

Trade: The U.S. trade deficit jumped from $40.1 billion in April to $45.0 billion in May. Exports shrunk by about 0.3%, as expected, but imports grew by 1.9%, indicating that the U.S. economy is stronger and improving compared with most of its trading partners. Global Purchasing Managers Index (PMI) data for the manufacturing sector was strongest for the U.S., with Europe second and China the weakest. This is probably not great news for those expecting China and other emerging markets to drive the world economy.

Quarter-end insights: Overall, it still looks like the economy is on the road to continued (if moderate) 2% growth, inflation is likely to remain below 2%, and long-term interest and mortgage rates are destined to go higher. When, not if, is the correct question to ask relative to interest rates. A tougher Fed and a tightening U.S. federal fiscal policy may keep a lid on short-term economic activity, but long-term fundamentals look strong.

Don't Let Small Numbers Distract You From the Big Picture

Even though it's all about dollars and cents, the financial industry runs on percentages; dollar signs are few and far between. The use of percentages is an understandable, and helpful, convention when communicating financial information. After all, a headline saying “Company A’s Net Jumps by 16%" is more helpful than one that reads "Company A’s Net Jumps to $1.02 billion.” Providing percentages rather than dollars also allows investors to compare apples to apples: You can readily discern that an investment that has gained 8% during the past 10 years has been a better bet than one that has gained half as much.

Yet dealing in percentages, especially relatively small ones like inflation rates, expense ratios, and long-term annualized returns, can also distract from important information that factors into your financial plan. Those small and innocuous-looking percentage figures, when translated into dollar terms and compounded over many years, can make a huge difference between success and failure.

How Small Numbers Can Make Your Investment Plan…: Say, for example, that you stick with the 3% 401(k) contribution rate that your company uses as the default, contributing $1,500 of your $50,000 salary for 40 years and earning 5% on your money. You'd have about $190,000 at the end of the period; not too shabby. But bumping up your percentage contribution just 2 percentage points (to 5%) would have a meaningful impact on your bottom line, increasing your nest egg to nearly $320,000.

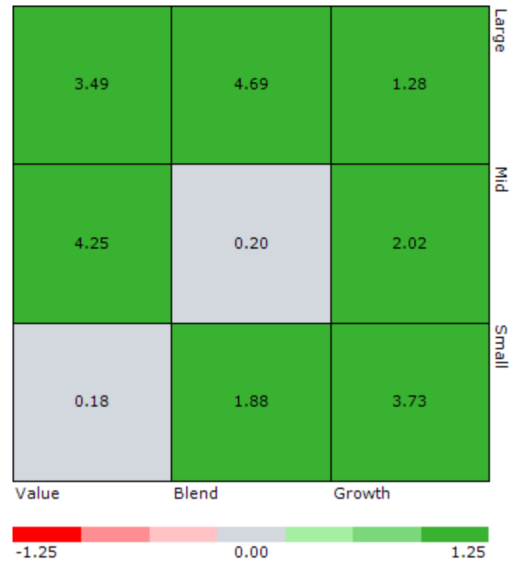
In a similar vein, you might choose to keep your child's college fund in cash. Assuming cash yields stay as low as they are now (which is, admittedly, a big assumption), a $50,000 investment that earns just 1% for the next 10 years will amount to just $55,000 at the end of the period. But by maintaining a 60% stock/40% bond portfolio and assuming a not unreasonable 4% return, you'd be able to grow your $50,000 investment to $74,000. Neither return rate will allow you to keep up with college inflation, sadly, but at least it's better than putting the money under your mattress. However, keep in mind that the 60/40 portfolio entails market risk.

…or Break It: Just as seemingly small percentage changes (either in contributions or return rates) can provide investors with an enormous helping hand, they can also work in reverse, and this is where many investors run into trouble. They blow off small percentage amounts like expense ratios and inflation rates when making investment decisions.

For example, let’s say an index fund has a fairly low expense ratio of just 0.63%. It's certainly cheaper than most actively managed funds, and it doesn't appear to be that much more expensive than most other S&P 500 index funds, some of which charge as little as 0.06%. If you opted for the expensive fund rather than a cheaper alternative and you held it for a long time, you'd be shortchanging yourself. Assuming a 10% annualized return and a $100,000 initial investment, you'd be leaving a lot of money on the table during a 25-year period by opting for the more expensive fund: nearly $170,000, to be exact. All because your fund charged 0.57% per year more than a comparable option.

Inflation is another factor that investors tend to underestimate, because the average historical inflation rate of roughly 3% looks pretty benign when viewed without any context. Should the fact that bananas that are $0.59 a pound today but might be $0.79 a pound 10 years from now cause a major rethinking of your financial plan? Yes, actually. When you extrapolate inflation across all of the items in your shopping cart and compound it over many years, it can have a hugely corrosive effect on the purchasing power of your savings, meaning you need to save a lot more than you thought you did.

Quarterly Market Barometer



3 Month, ending June 30, 2013. The U.S. Market returned 2.72% (YTD 14.04%).

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are “value” and “growth” while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.

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