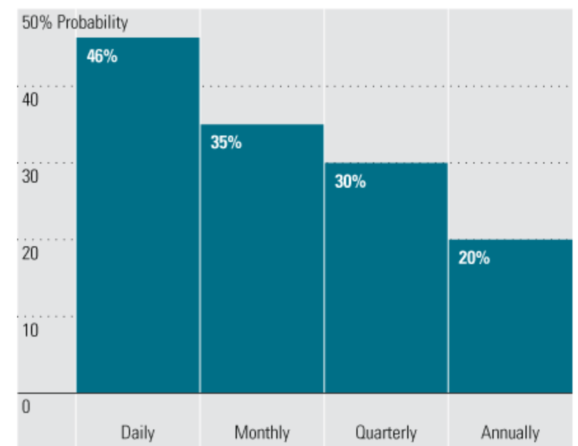
MITCHELL MCLEOD PUGH & WILLIAMS
INVESTMENT ADVISER

January 2012 | Volume 23 | Quarterly Newsletter

Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

Mitchell McLeod Pugh and Williams, Inc.
kpugh@mmpwadviser.com
251-471-2027

Mitchell McLeod Pugh & Williams, Inc. - Adviser Corner

We would like to remind our clients of important changes in tax reporting requirements that have taken effect as of January 1, 2011. The Emergency Economic Stabilization Act of 2008 mandates that custodians, broker-dealers, and transfer agents report adjusted cost basis of sold securities, including whether the gain or loss is short or long term, to the IRS and clients on Form 1099-B. These requirements are phasing in over three years, starting in 2011 for all equities (common stock) acquired on or after January 1, 2011. The second phase that covers mutual funds and most ETFs begins for those transactions occuring after January 1, 2012. The third phase begins in 2013 for bonds and options. Please keep in mind that our firm will continue to provide clients with gain and loss reporting as we have in the past. The primary difference is that your custodian will also be providing this information to you and the IRS for those covered transactions. Please contact us with any questions you may have upon receiving your 2011 1099-B.

Monthly Market Commentary

2011 ended with the S&P 500 almost flat after a tumultuous year. As Europe continued to be of concern, markets loved the coordinated central bank maneuver that ensured liquidity across global financial systems in order to calm panicky investors. Although a global economic slowdown is very real, given the possibility of a European financial contagion and a slowdown in China, the U.S. could potentially be the engine of worldwide growth in 2012.

Employment: December saw the addition of 212,000 private-sector jobs, mostly from large increases in delivery personnel, retail sales workers, and construction workers. The holiday season and the boom in online shopping activity accounted for the two former, while unusually warm weather in December helped the latter. While sizable, the private sector has lost 8.8 million jobs throughout the recession and has only gained back 2.8 million of these jobs. At current growth rates, three additional years are still required to recoup all these jobs. The government sector, on the other hand, continued to shed jobs (another 12,000 jobs in December). This brings the total number of government jobs lost since the recovery to almost half a million. The unemployment rate fell to 8.5% in December, aided mainly by increased employment with some help from labor force dropouts.

Manufacturing: Both government new-order reports and industrial-production reports indicated that the U.S. industrials sector was not declining, with some reports even showing signs of modest growth. Positive new-order reports are particularly important—they help predict production and employment in the upcoming months. The most-recent durable-goods order report reflected strong numbers for autos and airplanes, while others, such as non-defense capital goods, slowed. Higher inventory levels and better pricing for autos and Boeing's anticipated production jump to satisfy deliveries for its 787 Dreamliner contributed to these numbers.

Consumer: This holiday season was a great time to be a consumer, as opposed to a retailer. As consumers continued to spend and take advantage of phenomenal deals and discounts, some retailers saw their margins decline as a result. Luxury and low-end retailers did relatively well, but companies serving the middle market, such as Best Buy and Target, struggled. Apparel companies were hit especially hard, given the unusually warm weather in December.

Housing: Stringent lending standards and general attitudes toward home ownership continued to hold back the housing market despite housing affordability remaining at a record high with low prices and low mortgage rates (now below 4%). This could be seen in the 7.3% jump of pending home sales (homes that go under contract but have yet to close, pending appraisals and financing) in November compared with October, which are now at their highest levels in 19 months. However, the housing market continues to underperform, and home prices are still more than 30% below previous highs over the last decade. A catalyst, such as a stronger employment market, may be required before the housing market starts to improve significantly.

Year-end Insights: 2011 saw the U.S. economy grow, but at a much slower rate than predicted by many economists. Poor weather, oil and gas price shocks caused by political unrest in the Middle East, and supply-chain disruptions related to the Japanese tsunami all contributed to the first half's abysmal growth rates. Growth accelerated, as oil and gas prices fell back down and production facilities came back online in the second half of the year. 2011 also brought to light the severity of the European sovereign debt crisis and the slowdown of China's economy, causing investors and companies alike to sit on the sideline, weary of another global recession. Morningstar economists believe that the U.S. economy has more potential for upside than downside in 2012 as consumers continue to spend, manufacturing picks up, U.S. oil production increases, and the housing market becomes stronger.

Municipal Bonds and Tax-Equivalent Yields

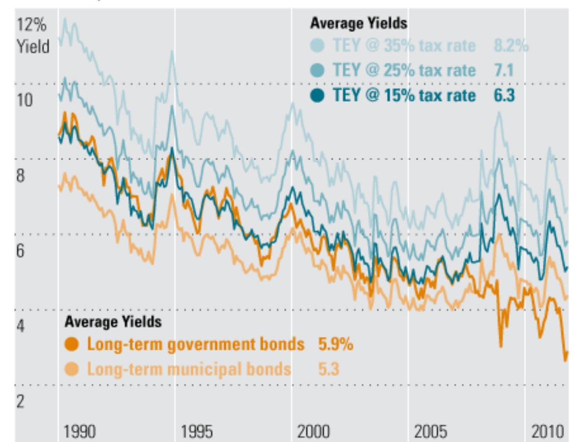
When building a portfolio, it is important for investors to take into account the ability of various investments to build wealth over time (their growth potential) as well as their potential to generate income. Bonds are debt instruments issued by governments, institutions, or corporations that pay interest periodically, making them a great choice for investors looking for current income. One downside to most types of bonds, however, is that the income they generate is subject to taxes. Municipal bonds are one exception.

Municipal bonds (munis) are issued by states, counties, cities, and other government entities and can be categorized into general obligation bonds or revenue bonds. General obligation bonds are backed by the "full faith and credit" of the issuer or its ability to bring in tax revenue. Revenue bonds are backed by income generated from specific projects or agencies. These bonds are often issued by hospitals and airports and are typically considered riskier than general obligation bonds.

Regardless of type, municipal bonds can offer an aftertax equivalent yield that is meaningfully above other bond investments. Yield is usually expressed as a percentage and can be described as the cash distributed periodically from an investment—similar to an interest rate. Municipal bond income is often protected from federal and state income taxes, making these investments desirable for investors in higher tax brackets, but capital gains taxes must be paid if the bonds are sold for more than their purchase price. One way to compare municipal bonds with taxable bonds is by calculating the tax-equivalent yield, which represents the before-tax yield an investor would need to achieve on a taxable bond in order to match a given municipal bond yield.

The image depicts yields for long-term government bonds, long-term municipal bonds, and municipal bond tax-equivalent yields for three different tax brackets. During the time period studied, average municipal bond yields have been below average long-term government bond yields—5.3% compared with 5.9%. However, average tax-equivalent yields have ranged between 6.3% and 8.2%—depending on the tax rate. The higher an investor's marginal tax rate, the greater their tax-equivalent yield will be and the more desirable municipal bonds are as an investment. For example, an investor in the 35% tax bracket not investing in municipal bonds would need an investment producing an 8.2% before-tax yield in order to match a municipal bond yield of 5.3%. An investor in the 15% tax bracket would only need an investment producing a 6.3% before-tax yield. Historically, tax-equivalent yields for all tax brackets analyzed have exceeded long-term government bond yields.

Municipal Bonds and Tax-Equivalent Yields
January 1990–October 2011



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Government bonds are guaranteed by the full faith and credit of the United States government as to timely payment of principal and interest, while municipal bonds are not guaranteed. State taxes have been ignored in estimating tax-equivalent yields. Municipal bonds may be subject to the alternative minimum tax (AMT) and state or local taxes, and federal taxes would apply to any capital gains distributions.

Source: Long-Term Government Bonds—20-year U.S. Government Bond; Municipal Bonds—Barclays Municipal Bond 20-year index; Federal tax rates from the Internal Revenue Service.

Stretching an IRA

Many retirees depend on their individual retirement accounts to fund living expenses during their golden years. However, there are retirees who find themselves in the enviable position of having no need to withdraw from their IRAs. If you are fortunate enough to be in this camp, or if you are fairly confident that you will have plenty of money left in your account when you leave this world (even after taking required distributions), you will want to make sure you preserve as much of your IRA assets as possible for future generations. You can accomplish this by implementing a stretch strategy.

The first step in setting up a stretch IRA strategy is to simply name one or more beneficiaries. If you are married, your spouse can serve as your primary beneficiary while your children or even grandchildren can serve as your secondary beneficiaries. You can also name others as beneficiaries, such as family members or friends. You worked hard to accumulate the funds in your IRA, be sure they are transferred properly.

When you pass on, providing certain conditions are met, each beneficiary who elects to go with a stretch strategy will have a range of options to choose from—depending upon your age at death (and whether or not you have begun to take required minimum distributions from the IRA) and whether a spousal or non-spousal beneficiary is involved. If you happen to be named a beneficiary and choose to implement a stretch strategy, be sure you know what comes next. In some cases you may be able to keep the assets growing on a tax-deferred basis while in other cases distributions will need to be taken soon. Because of the many rules, it is highly advisable that you speak with a financial advisor or tax professional when it comes to stretch strategies.

©2012 Morningstar, Inc. All Rights Reserved. The information contained herein (1) is intended solely for informational purposes; (2) is proprietary to Morningstar and/or the content providers; (3) is not warranted to be accurate, complete, or timely; and (4) does not constitute investment advice of any kind. Neither Morningstar nor the content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. "Morningstar" and the Morningstar logo are registered trademarks of Morningstar, Inc. Morningstar Market Commentary originally published by Robert Johnson, CFA, Director of Economic Analysis with Morningstar and has been modified for Morningstar Newsletter Builder.

Mitchell McLeod Pugh and Williams, Inc.
2610 Dauphin Street
Mobile, Alabama 36606
kpugh@mmpwadviser.com
Tel:251-471-2027
Fax:251-471-2302