Investor Insights & Outlook

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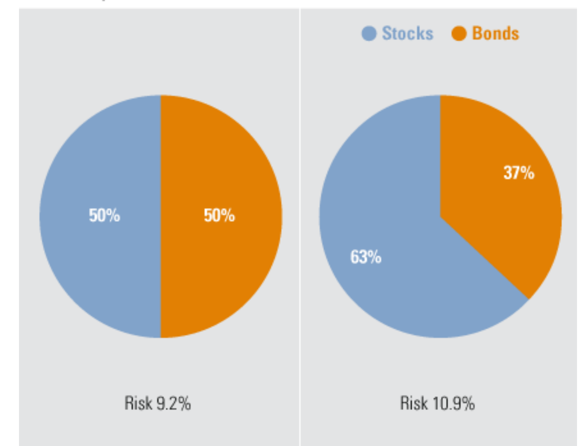
The Importance of Rebalancing

Over time, your asset-allocation policy can veer off track because of market ups and downs. This is illustrated quite clearly in the attached image; a strong stock performance can cause a simple 50/50 portfolio mix to become unbalanced over time. After 30 years, what was once a 50% allocation to stocks now sits at 63%—quite a jump. Moreover, not only does the portfolio's allocation change, but the portfolio's risk also changes, rising sharply from 9.2% to 10.9%. If your needs and/or risk tolerance have not changed, your allocation shouldn't either.

But why would anyone want to sell investments that have done great in order to purchase laggards? While rebalancing might seem odd at first, it is all about risk control. If more and more of your total portfolio winds up in one investment, you risk losing a lot should that investment stumble.

Change of Portfolio Allocation:
January 1981–December 2010



Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The sale of an investment for the purposes of rebalancing may be subject to taxes. Risk is measured by standard deviation. Standard deviation is a statistical measure of the extent to which returns vary from the expected returns. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. Stocks are not guaranteed and have been more volatile than bonds.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and is considered to be representative of the stock market in general; Bonds—five-year U.S. Government bond.

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Dividends and Total Return

Income is important to consider when choosing an investment. Especially important for investors approaching retirement, income can add meaningfully to one's total return, which comprises income and price return (capital appreciation). Investors can pursue income returns in many ways including bonds, real estate investment trusts, and stocks.

Stock income is typically paid in the form of a monthly, quarterly, annual, or special cash dividend, which can be used to finance current consumption or to reinvest. Dividends are typically expressed in terms of yield. Like an interest rate, yield is represented as a percentage rate and is calculated by taking the annual cash dividend divided by a stock's current price. For example, a stock trading at $20 with a future annual cash dividend of $1 would have a dividend yield of 5%.

Keep in mind, though, that there is no guarantee a dividend will be paid, even if a certain company has a consistent dividend-paying track record. A company can increase, decrease, and even eliminate dividends altogether, depending on its financial situation. Furthermore, if a dividend is declared, the company has to pay dividends for preferred shares first, before any common share dividends can be paid.

Although stocks can be a source of income return, not all stocks are created equal in this regard. Some companies distribute significantly more of their profits in the form of dividends than others, and some don't distribute dividends at all. The following image demonstrates this point. Historically, dividend-earning stocks—represented by Morningstar's Dividend Composite Index—have had compound annual returns of 6.9%, while large stocks have had compound annual returns of 5.0%. Additionally, higher-yielding companies—represented by Morningstar's Dividend Leaders Index—have outperformed large stocks: Dividend Leaders Index components had a compound annual return of 9.0% compared with 5.0% for large stocks during the period studied. For investors looking both for income and total returns, dividend-paying stocks can be a reasonable place to invest.

Although higher-yielding stocks have demonstrated an ability to outperform large stocks, all that glitters is not gold. Dividends are paid at a company's discretion, and exceptionally high yields can indicate a potential dividend cut. For example, had investors been lured to many high-yielding bank stocks in late 2008, they would have been sorely disappointed when many banks subsequently cut their dividends as profitability declined during the credit crisis. When looking at dividend-paying stocks, investors should focus on reasonable dividend yields with companies that have the earnings power to increase their dividend distributions over time. Many large companies with recognizable brand names have demonstrated an ability to offer this slow and steady income distribution to shareholders.

Dividend-Paying Stocks
May Provide Better Returns

This is for illustrative purposes only and not indicative of any investment. Assumes reinvestment of all income and no transaction costs or taxes. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. Dividends are not guaranteed and are paid solely at a company's discretion.

Source: Large Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Dividend-Paying Stocks—Morningstar Dividend Composite Index; High-Yield Dividend-Paying Stocks—Morningstar Dividend Leaders Index. Stocks in both indexes have a consistent record of dividend payment, have the ability to sustain their dividend payments and are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index. The Morningstar Dividend Leaders Index captures the performance of the 100 highest-yielding stocks.

Make the Most of Company Benefits

When the time comes to sign up for next year's company benefits, it is important that you take the time to review all your options and maximize your alternatives. While this is usually no easy task, be sure to read these over and ask the pertinent questions.

Don't assume you know all the details of your health-insurance package. It is extremely important that you fully understand your health-insurance plan and your plan choices. What is your deductible? What is your out-of-pocket maximum? Do you have a co-pay and how much is it? What types of services (preventative/routine) are covered? Be sure to examine your prescription drug coverage while you are at it. Does your company provide dental and vision benefits as well? All of this information and much more can be obtained from your company's human resources department. The HR representatives are also there to help you with questions that arise while browsing through your benefits booklet.

Don't leave any "free" retirement match money on the table. Having a good retirement plan is usually considered the second most important benefit. By allowing your savings to grow tax-deferred for many years, this can pay off huge at retirement. An ideal retirement plan will offer a company match, great investment choices in a number of different asset classes, low expenses, and a strong advice program to help you make the best choices. If your employer will match all or part of your contribution, it is imperative that you take advantage of it, if at all possible. Why would you want to leave free money on the table? If your budget is tight right now, at least contribute some percentage of your salary. Each year, increase your contribution by at least 1% until you're setting aside the maximum allowed.

If you are lucky enough to also have a pension plan in addition to your 401(k) or other retirement-savings plan, learn exactly how the company will calculate your benefits. It's usually based on a formula that factors in years of service and average pay when you retire.

Consider disability insurance. Being out of work for an extended period of time can have a devastating financial impact on your family. The good news is that many employers offer disability insurance. And if you buy this insurance through your employer, you'll usually pay less than if you purchased it on your own. The bad news is that only a small percentage of employees sign up for long-term disability coverage. You may think nothing will ever happen to you, but you'd be surprised how often people need to take advantage of this benefit. Short-term disability typically covers benefits for one year or less. Many times your employer will automatically cover any short-term disability. Long-term coverage typically replaces 50% to 70% of your former salary, and is not an automatic benefit for every employee.

Don't leave your family unprotected without life insurance. Not everyone needs life insurance. If you're single and have no dependents, you might be able to skip this benefit. But if you have a spouse and/or children, you'll need to consider how much insurance is enough. Term-life insurance is by far the most common form of company-offered life insurance. This type of policy pays the beneficiary a predetermined amount of money. Term-life insurance just covers the basics—it doesn't offer the ability to build up cash savings the way whole-life policies do. If you don't currently have a policy outside of the one offered through your employer, investigate how much the premiums would cost you.

Other benefits to investigate. If you're lucky, other options might be offered by your employer. These include flexible-spending accounts, stock options, stock-purchase plans, employee stock-ownership plans, and more. Choose wisely.

Responsible Investing with Socially Conscious Funds

A socially responsible or socially conscious mutual fund seeks to maximize returns by only investing in companies that adhere to strict ethical and moral standards. For example, some socially responsible funds make investment decisions based on environmental responsibility. Among these, alternative-energy funds primarily invest in companies whose main business is energy coming from sources that do not pollute and do not deplete natural resources. Other socially conscious funds concentrate on human rights by refusing to profit from unethical business practices such as child labor, exploitation, discrimination, or unhealthy workplace conditions. Another category includes funds that invest based on religious principles.

Generally, all socially responsible funds refuse to invest in firms that manufacture or distribute weapons or are involved in the defense industry. They also avoid companies involved in promoting alcohol, tobacco, or gambling. Investors interested in such funds should examine the fund's prospectus to determine the manager's exact philosophy, and whether the manager's definition of "socially responsible" is in line with their own. Keep in mind that although a mutual fund might categorize itself as socially responsible, this does not guarantee attractive returns.

Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges, expenses and other information about the investment company. Investors should read the prospectus carefully before investing or sending money. Past performance is no guarantee of future results. The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost.

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