Investing With Integrity

January 2012 | Vol. No. 7 | Investment Updates

TIPS to Inflation Proof Your Portfolio

When signs of inflation creep into the economy, investors seek to protect their portfolios by turning to defensive market sectors (utilities, health care). But certain fixed-income investments, like Treasury inflation-protected securities, or TIPS, can be just as useful.

The interest rate does not change over the life of TIPS, but the underlying principal rises and falls with changes in the inflation rate. So the amount an investor will receive as income also changes. At maturity, you either receive the adjusted principal or the original principal, whichever is larger. The table singles out those years since 1990 when inflation was 3.0% (its long-term average) or higher and shows how TIPS fared. Out of the seven years illustrated in the table, TIPS outperformed inflation in five of them—and by a considerable margin.

TIPS Performance During Inflationary Periods: 1990–2010

Year	Inflation	TIPS
1990	6.1	23.9
1991	3.1	–13.7
1996	3.3	7.2
2000	3.4	13.2
2004	3.3	8.5
2005	3.4	2.9
2007	4.1	11.8

Advisor's Corner

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Charles Blozinski, CFP and Thomas Goodwin, CFP, EA offer their clients the advantage of over 35 years of combined experience in financial services. They work as an interactive team to provide independent, unbiased financial advice in a fee-only environment. Integrity Financial Planners is a registered investment advisor in the State of Oregon.

What Is Up with Gold?

Integrity:

- Gold and other commodities are an important part of a diversified investment portfolio.
- These commodities move up and down in value independent of the equity and fixed-inccome markets. These low correlation helps reduce the volatility and risk in a diversified portfolio.

With the runup on gold during the past few years, many investors have been enamored with its short-term performance and are aching to jump into it. Never mind that gold itself has almost no intrinsic value or that the price is largely determined by what other buyers are willing to pay. The past decade, with market crashes and uncertainty, has caused many investors to flee to the safety of gold, but looking longer term, gold might not be as attractive as it appears. An investment of $100 in stocks beginning in 1980 would have grown to $2,838 by November 2011. That $100 invested in bonds over the same time period would now be $2,186. And if one had invested that $100 in gold in 1980, it would be a measly $333 today.

History has shown that given the volatility of the price of gold, both stocks and bonds outperformed gold in the long run over the past 30 years by providing higher average returns. Stocks and bonds also outperformed gold over a 20-year time period. A starting point of 1980 was chosen because, not unlike today, the price of gold was then at all time highs. With gold fervor rampant, a speculative investment in gold, then, would have resulted in not-so-stellar results today, even with gold's recent performance.

Gold is not without its merits. It has traditionally been considered a good hedge against rising inflation rates, given its ability to preserve purchase power. Gold is also commonly considered a safe haven in times of political and currency crises. As fears of a double-dip recession mount, gold may be considered a tool for diversification, because it generally does not react identically to the same economic or market stimuli as stocks and bonds. A well diversified portfolio of stocks, bonds, and gold has the potential to produce a more appealing risk-and-return trade-off over various time periods.

Compound Annual Returns

	1 yr	3 yrs	5 yrs	10 yrs	20 yrs	30 yrs
Stocks	7.8	14.1	–0.2	2.9	8.3	10.8
Bonds	19.4	8.5	9.5	8.4	9.0	10.6
Gold	26.2	28.9	22.0	20.3	8.1	4.9
60/40 portfolio	12.9	13.2	5.3	6.2	9.4	11.4
50/40/10 portfolio	14.7	14.6	7.4	7.9	9.5	10.9
50/30/20 portfolio	15.3	16.5	8.5	9.0	9.4	10.4

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Gold, like any other coin or bullion, is subject to investment risks like perceived scarcity, its quality, current demand, market sentiment, and economic factors. There are material differences between investing in gold versus investing in stocks and bonds. Such differences may include investment objectives, costs and expenses, liquidity, safety, fluctuation of principal or return, insurance, tax features, and any other investment characteristics.

Source: Data as of November 30, 2011. Stocks in this example are represented by the S&P 500® index, 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 20-year U.S. government bond. Gold is represented by the Federal Reserve (2nd London fix) from 1980-1987 and the Wall Street Journal London P.M. closing price thereafter. Portfolios are rebalanced every 12 months.

Municipal Bonds and Tax-Equivalent Yields

Integrity:

- Integrity Financial Planners has an Enrolled Agent and Oregon Licensed Tax Consultant. Give us a call if you would like help determining if Municipal Bonds are appropriate for your portfolio.

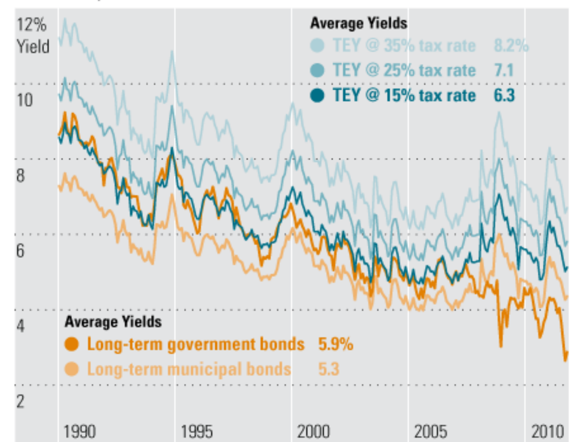
When building a portfolio, it is important for investors to take into account the ability of various investments to build wealth over time (their growth potential) as well as their potential to generate income. Bonds are debt instruments issued by governments, institutions, or corporations that pay interest 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.

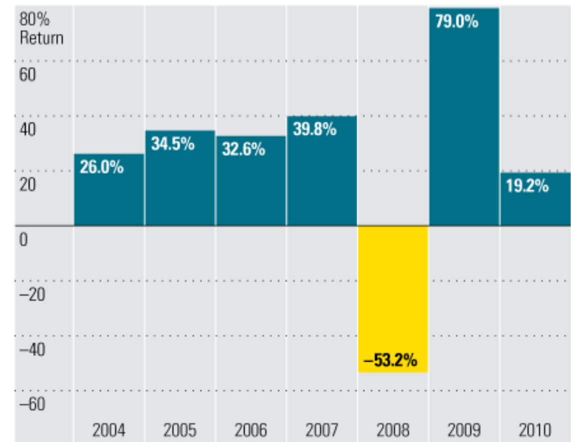
Overconfidence: False Perception

Integrity:

- Emotional investing
- Trying to time the market
- Buying high, selling low
- These are all investment issues which can distract investors from their long term goals. Here at Integrity, one of our roles as financial advisor is to remove the emotional and impulse reactions to the markets which can hurt your long term results.

Consider the performance of emerging-market stocks from 2004 to 2010. For the first four years, stocks in these regions produced impressive returns. Based on this stellar track record, a typical investor may expect more of the same. Well, 2008 was quite dismal for emerging-market investors, as they lost more than half of their investment—53.2%. In 2009, however, emerging markets rebounded, producing a return of 79.0%. In 2010, emerging-market returns were still positive, but down to 19.2%. When investing, investors must consider the possibility of another year like 2008 in the future. Strong positive returns may be enough to create overconfidence among investors. Investors should avoid overestimating their ability to predict future outcomes and avoid focusing on only the upside potential while dismissing the possibility of poor performance.

Historical performance of emerging-market stocks 2004–2010



Source: Emerging-market stocks are represented by the Morgan Stanley Capital International Emerging Markets Index. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. 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. Emerging-market investments are more risky than investments in developed markets.

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