

# Information You Should Know

June 2010

Issue No. 1

Timely Information from Brightscape

## 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: 1990–2009

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	2.8
2007	4.1	11.6

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. TIPS carry individual and unique risks.

Inflation-protected bond portfolios primarily invest in fixed-income securities that increase coupon and/or principal payments at the rate of inflation. These bonds can be issued by any organization, but the U.S. Treasury is currently the largest issuer of these types of securities. Most of these portfolios buy bonds with intermediate- to long-term maturities.

Source: TIPS are represented by the Ibbotson Associates TIPS Index. Inflation is represented by the Consumer Price Index.



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### Advisor Corner

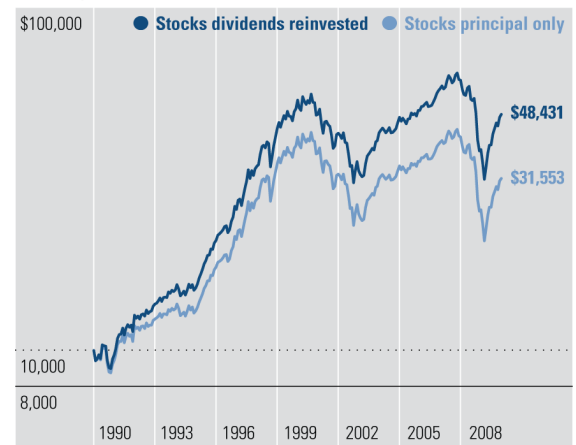
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## Dividend Discussion

For many investors, the only reward that matters is an increase in share price. But if you look beyond capital gains, you might find a dividend offering significant benefits. A dividend can (1) provide regular income, (2) grow over time through reinvestment opportunities, and (3) offer significant tax benefits. Prior to the 2003 Tax Act, dividends were taxed at ordinary income-tax rate levels, which could be as high as 35%. Now investors pay significantly less taxes, ranging from 5% to 15%.

Despite these advantages, dividends seem to be an often overlooked component of total returns. The image below illustrates the impact that reinvested dividends have on investment returns over time. These paying investments can add value to a portfolio, but keep in mind that it is possible to lose money by investing in them, and that companies cannot always guarantee their dividend payments.

Growth of \$10,000:  
Principal Versus Reinvested Distributions



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Source: Stocks with dividends reinvested—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Stocks principal only—Standard & Poor's Capital Appreciation.

## Borrowing from Your Retirement

Barbara is 40 years old, has a child in college, and needs to take out a loan to help with tuition. She is considering either a home-equity loan or a loan from her 401(k), and is not sure which would be the better choice. She has heard that taking out a loan from a 401(k) is painless, since “you don’t pay penalties and pay the interest to yourself, not to a bank.” What should she do?

Many 401(k) plans offer a loan provision and the process is fairly easy. There is no credit check (since you are borrowing from yourself); the interest rate is usually low (maybe a percentage point or two above prime); you can generally borrow up to 50% of your vested account balance to a maximum of \$50,000; you have up to five years to repay the loan (longer for loans used to purchase a primary residence), and the plan administrator usually deducts the loan payments automatically from your paycheck.

However, the real cost of borrowing from your 401(k) is not the rate you pay yourself in interest, but the amount you would have earned on your balance had you just left the money in the account. This is called an “opportunity cost,” and it can be significant. In addition, if Barbara loses or changes jobs, a 401(k) loan will most likely come “due in full” within a limited amount of time, while a home-equity loan will not. The balance is taxed as if it were ordinary income and, unless she is at least 59½ years old, failure to pay the 401(k) loan back by the due date triggers a 10% penalty.

So, what are Barbara’s choices? In general, if she can take out a home-equity loan at a lower after-tax cost than the return she expects to receive on her 401(k), she should choose the home-equity loan.

## Potential Pitfalls of Bond Investing

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Bonds present investors with a number of potential benefits. In general, bonds have provided investors with growth and less risk than stocks historically. Economic events that tend to decrease stock prices have sometimes increased bond prices, and vice versa. Because of this relationship, adding bonds to a portfolio might provide significant diversification benefits. Lastly, bond investors normally receive income at fixed intervals, helping to meet certain cash-flow needs. However, as with any other investment, there are some risks that investors need to be aware of when adding bonds to an investment portfolio.

**Interest-Rate Risk:** Bonds and interest rates have an inverse relationship—bonds tend to rise in value when interest rates fall and fall in value when interest rates rise. Suppose an investor purchases a 20-year \$1,000 bond with a yield of 8% and interest payable annually at year-end. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for \$1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower coupon payments.

**Inflation Risk:** This is also known as purchasing-power risk. Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past. At their best, bonds have experienced very modest inflation-adjusted returns. Long-term government bonds returned 2.3% on an inflation-adjusted basis from 1926 to 2009, and long-term corporate bonds produced an inflation-adjusted return of 2.8%. Stocks, on the other hand, returned 6.6% inflation-adjusted.

**Credit Risk:** This is the risk of a company that is selling bonds not being able to make timely payments of principal and interest. The value of a bond might also decrease because of financial difficulties or the declining creditworthiness of

the issuer. It is important to keep in mind that corporate bonds aren't guaranteed by the full faith and credit of the U.S. government but are solely dependent on the company's ability to repay the money that it has borrowed.

**Liquidity Risk:** Some investments might not be widely held by the public and can be difficult to sell (are not very liquid) if prices drop dramatically. Government bonds are usually very liquid investments; corporate bonds, however, might be difficult to sell quickly in certain situations.

**Call/Reinvestment Risk:** As interest rates fall, bonds with call provisions might be called (redeemed) by the issuer prior to maturity. While a premium is usually paid to the bond owner when the bond is called, this could leave the investor with the problem of reinvesting the principal at a lower interest rate.

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 and corporate bonds are not guaranteed. Stocks have been more volatile than the other asset classes. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Source: Stocks in this example are represented by the Standard & Poor's 500<sup>®</sup>, which is an unmanaged group of securities and considered to be representative of the stock market in general. Corporate bonds are represented by the Ibbotson Associates long-term corporate bond index, government bonds by the 20-year U.S. government bond, and inflation by the Consumer Price Index.

## The Rising Cost of Health

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While many people are putting aside money for college costs, retirement nest eggs, and other predictable financial goals, not many make it a point to save money for health care costs. Whether they think that their insurance will cover most costs, or they aren't planning for the unexpected, many Americans find themselves unprepared to pay medical bills.

Health care insurance plans through a place of employment or Medicare can take care of many medical bills, but these plans have limits that can quickly be exceeded. In addition to the costs not covered by insurance, there is the rising cost of the insurance policy itself. As baby boomers get older, there will be a surge of insurance claims, which may increase the overall cost of health care policies. To make matters worse, in May 2009 the government stated that the Medicare fund that pays hospital bills for older Americans is expected to be depleted in 2017, rather than 2019 which had been previously projected.

We cannot predict the rate of increase for medical costs in the future, but recent history tells us that medical costs have been rising at an alarming rate. According to the Bureau of Labor Statistics, medical costs have risen by an average of 4.6% per year over the last 20 years (1990–2009). This is a significant increase in prices: The average annual increase for all goods and services over that time frame was 2.7%.

In order to improve the struggling health-care system, President Obama signed the Patient Protection and Affordable Care Act on March 23, 2010. The legislation brings about a series of changes, some of which will be seen immediately, and some of which will not take effect until 2014. One probable consequence of this new law is that insurers, faced with additional costs, will probably raise premiums in order to compensate. The best strategy is to prepare for these rising costs by saving and investing enough to meet these needs as they arise.

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