

INVESTMENT UPDATE

THE MUNCY BANK & TRUST COMPANY

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Points of interest:

- Inflation has not disappeared; the current rate is 2.3 percent.
- Ten-year Treasuries are paying only 1.79 percent.
- Stocks have returned 4 to 5 percentage points above inflation over the long-term.
- Experts say investors should expect real stock returns of 2 to 3 percentage points over inflation.

STOCKS ARE SCARY TO OWN, BUT THEY ARE YOUR BEST INFLATION FIGHTERS

Individual investors have fled the stock market in droves ever since the great bear market of 2008. The latest statistics show investors selling more stock mutual funds than they buy and putting much of the proceeds into bond funds.

Meanwhile market volatility has increased again as another round of scary financial headlines from Europe have pushed prices down sharply in recent weeks.

Investment sentiment indicates investors are willing to accept very low interest rates on bond investments because they are more concerned about the return of their money than the return on their money.

A big blunder?

This may be a big mistake for those planning to use their investments to fund a lengthy retirement.

Despite slow economic growth, and even some contraction around the world in recent years, inflation remains an ever-present threat.

The most recent government reading gauged inflation at a 2.3 percent annual rate. While that is below the long term average of about 3.5 percent, it still poses a problem for investors who are hiding in fixed income investments.

Currently bank deposits, money market mutual funds, and short-term U.S. Treasury bills are paying virtually nothing.

Investors willing to risk locking in a rate for 10 years on a U.S. Treasury will get only 1.79 percent.

That would mean a loss in real purchasing power—after taxes the interest paid on the 10-year investment would be less than the current rate of inflation.

Lower, but real returns

Stocks, of course, have not been generating any great returns lately either, but they have the potential for total returns going forward that will beat inflation, while bonds are likely to be losers (except in the case of a new Great Depression accompanied by

massive disinflation).

Since World War II investors have been used to getting returns of 4 or 5 percentage points above inflation on stocks. Although forecasters say those days may be over for a while, they say that diversified investors still should be able to manage 2 to 3 percentage points above inflation in the stock market.

It may also feel painful as you wait for those returns—there will be plenty of short-term periods when stocks lose value and the markets look scary. But the only rational response is to stick with a

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A lengthy bear market drove many individual investors out of stocks and into bonds and bank deposits offering very low interest rates.

DIVERSIFY AND KEEP ADDING NEW MONEY TO IMPROVE YOUR RETURNS

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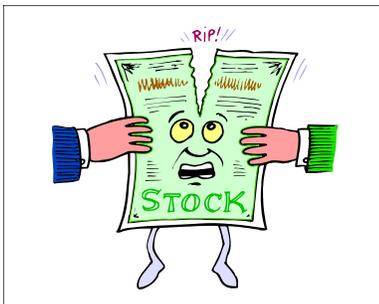
diversified portfolio and try not to react to the market's ups and downs. Statistics kept by research firm Dalbar consistently find that mutual fund buyers who buy and sell rather than staying invested all the time routinely make timing mistakes and end up getting much lower returns than they would have if they just stayed invested.

Juice your returns

An investor who bought an index of big American

stocks at the beginning of this century has had a return of less than 2 percent per year. But a more diversified portfolio that includes a mix of big and small stocks, international and domestic stocks, domestic and international bonds, and commercial real estate trusts has done better.

A balanced index with 60 percent in stocks and 40 percent in bonds has returned 6.5 percent per year since January 2000, says Dimensional Fund Advisors.



Some investors have given up on stocks.

Investors who gradually invested money into the markets over the same period would have done better, buying more shares at low prices.

IS THIS THE LAST GENERATION TO USE 401KS?

The 401k retirement savings account offered by employers has become ubiquitous over the last 30 years. But some retirement planning experts predict that 401ks will be overtaken by a new form of retirement savings in the future.

The reason is simple: the accounts don't help lower income employees who lack the ability to save for retirement, and they put each saver at individual risk, without the ability to pool risks with a lot of other savers.

Remember pensions?

Those were precisely the advantages that used to make traditional pension plans a hit for employees. They didn't have to sacrifice current earnings to contribute to their pensions, and the investment risk was borne by everyone in the pension so that no one individual was subject to a sudden market decline.

Instead, each 401k owner is on his or her own when it comes to investment risk, and

each employee must save up enough money to fund their own retirement. It is a daunting task, retirement experts say.

Some have advocated allowing the states to open up their public pension plans to small private employers, allowing employees to buy into the state pension plan by transferring in their 401k assets.

Others have advocated a new mechanism within 401k plans that would

force employees to allocate their money into an annuity-like account that would guarantee a lifetime income off of their assets. Some proposals would allow employees to still share in some guaranteed market growth as well as

change their minds and withdraw assets at any time.

What to do now

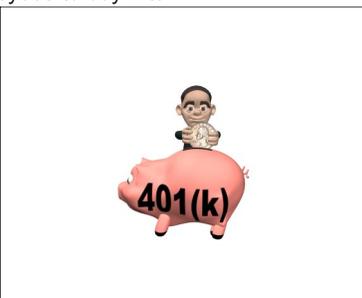
As these options are debated, experts recommend that employees over 50 not make any rushed moves.

Now is not a good time to lock up 401k money in a fixed rate annuity, partly because rates are so low and partly because improved offerings may be coming in the future.

Also don't expect that you will be stuck with your company's 401k offerings. At retirement you will be allowed to roll your account

over to an Individual Retirement Account and then take advantage of competitive offerings from all of the major investment providers.

Finally, keep socking money away so that you can buy a bigger benefit someday.



The 401k plan that we use today may evolve into a lifetime income product or may even become part of a public pension plan, experts say.

"Some have advocated allowing the states to open up their public pension plans to small private employers."

PUBLIC PENSION FUND TRAVAILS SHOW THAT RISK AND FEES MATTER

Some pension funds for state and local employees have sought higher risk investments in order to boost returns and make up for funding shortfalls. Others have stuck to a traditional diversified stock and bond mix.

Guess who has done better? (Here's a hint: it wasn't the pension plans that took high risks).

The tax squeeze

Falling tax revenues and rising retirement costs have put some public pension plans on the defensive. In an attempt to make up for shortfalls they began putting some of their assets into hedge funds, direct real estate investments, and private equity arrangements.

Hedge funds are investment pools that have no constraints on their strategies: they can short stocks, speculate in currencies, and engage in other risky pursuits. Private equity funds allow large investors to take direct ownership stakes in private businesses, rather than buying publicly-traded stock.

The New York Times recently reported that the Pennsylvania State Employees' Retirement System has put almost half of its assets into private equity, real estate, and other riskier alternative investments.

The pension fund had average returns of only 3.6 percent over the past five years, and it paid \$1.35 billion in management fees.

Meanwhile, the Georgia municipal retirement system is prohibited by law from using such investments. It invested in a standard diversified mix of stocks and bonds and earned a 5.3 percent annualized return over the same period, while paying about \$54 million in management fees.

Poles apart

London-based alternative investment research firm Prequin recently said that Pennsylvania was among a group of pension systems taking the highest risks, while



Fees paid for higher risk investments did not bring higher returns for pension funds.

Georgia's system was in the group taking the lowest risks.

Prequin's study showed that those pension funds that had over one-third of their money in riskier alternative investments earned an average of one percentage point less than pension funds that avoided such investments. Meanwhile the riskier pension funds paid an average of four times more in fees.

The results seem to indicate that the returns on alternative investments do not justify their higher fees.

“Those pension funds that had over one-third of their money in riskier alternative investments earned an average of one percentage point less.”

POLITICAL GAINS, BIG PAYOUTS, & MORE

Presidential election years have generally been good for the U.S. stock market. Stocks have gone up in 14 of the last 19 election years, and the average gain has been 6.2 percent per year.

The worst years were 1940, when Germany invaded France in World War II, and 2008, when the fall of Lehman Brothers triggered a financial crisis. The year 2000, when the technology stock bubble burst, was also bad.



If those three years are excluded average returns have been 11 percent.

Long-term care payouts

Buyers often balk at the cost of long-term care insurance. But for those who need care, the payouts can be large, says the American Association for Long-term Care Insurance.

One buyer currently has collected \$1.7 million over 15 years. The policy owner bought her coverage at age 43 at a cost of \$881 per year; she began needing care

and taking benefits three years later at age 46.

Retirement differences

Women and men approach retirement differently, found a survey by Ameriprise Financial.

Women are more likely to think about their lifestyle goals, which include proximity to family. They are more likely to think about activities they want to engage in.

Men concentrate on finances, such as the amount of income they will need to live on, and are more likely than women to plan the financial aspects of retirement.

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INVESTORS ARE SITTING ON WADS OF CASH JUST AT THE WRONG TIME

The latest consumer inflation rate was clocked at 2.3 percent in April. Sounds pretty benign, doesn't it?

Well it isn't if you are keeping large sums of money in the bank at today's interest rates.

In fact, "safe" money in the bank is being subject to erosion just as surely as any stock market decline might affect your investment portfolio.

As any saver knows, interest rates on bank deposits, money market mutual funds, and short-term U.S. Treasury Bills are miserable, hovering close to zero. And the Federal Reserve Board, which manipulates short-term interest rates in order to achieve its dual mandate of low inflation and full employment, has vowed to keep rates at current levels into the year 2014.



Savers are losing money due to inflation and low interest rates.

But scared investors are sitting on a ton of cash, even as they worry about the threat of inflation, found a survey done for MFS Investment Management.

The average investor has 26 percent of his or her portfolio in cash because they are scared to invest in a volatile market environment. The cost of that perceived safety is a decline in purchasing power.

As each day passes and inflation rises, money held at the bank will purchase fewer goods and services.

Although everyone should keep a cash store in a safe place for emergencies, it is detrimental to your wealth to hold excess cash these days.

Savers have two good alternatives. One is to use some of the excess cash to pay down debt. Almost any loan today, from a mortgage to a credit card balance, is charging more interest than you are making at the bank.

The second alternative is to invest some of the cash into a diversified portfolio that includes stocks and bonds. Yes, you will have to bear market volatility, but higher rates on bonds and capital appreciation on stocks will give you a fighting chance to beat inflation.