

INVESTMENT UPDATE

THE MUNCY BANK & TRUST COMPANY

INSIDE THIS ISSUE:

- | | |
|---|---|
| <i>Too many workers claim Social Security early and leave money on the table.</i> | 2 |
| <i>Investors who continue to fret over the 2008 crash miss the bull.</i> | 3 |
| <i>The college savings shortfall, long-term insurance risks, and more.</i> | 3 |
| <i>Large stock mutual funds are more correlated to their indexes.</i> | 4 |

Points of interest:

- Stock market returns have not correlated well with economic growth.
- Stocks seem to offer a higher average return than predicted by growth statistics.
- Stocks' higher returns probably compensate investors for the risk of losses that come at inconvenient times.

FORGET ECONOMIC GROWTH: STOCKS COMPENSATE FOR RISK

Periodic arguments that long-term stock market returns are a thing of the past have cropped up again, with noted bond investment manager Bill Gross calling the stock market a "Ponzi scheme."

He argues that U.S. stocks returned 6.6 percent per year over inflation during the last century, while gross domestic product, a measure of changes in the country's production of goods and services, has grown by only 3.5 percent per year.

"Somehow stockholders must be skimming 3 percent off the top each and every year," Gross writes. He believes the stock market cannot continue to offer such high real investment returns in the future.

But GMO, an international investment firm with its U.S. headquarters in Boston, argues that stock prices do not necessarily coincide with GDP. In fact, it is the painful occasional stock market crash, which usually comes at the worst possible time, that causes stocks to offer a real return of about 6 percent.

It's inconvenient

The most likely explanation for the substantial premium that stocks seem to pay over inflation are the "extremely inconvenient times that equity markets tend to lose investors' money," writes Ben Inker, head of asset allocation for GMO. He says severe market drops tend to



Stocks aren't priced along with economic growth. Rather, they offer higher returns to compensate for inopportune price declines.

occur in "recessions (bad), financial crises (very bad), depressions (very, very bad), and major wars (not good at all)."

From the beginning of the 20th century until now, "while the average return to the S&P 500 over this period was a reassuring 6.6 percent real, at those times when you were most at risk of losing your job, your bank account, your house, or your life, you could rely on equities to be piling on the misery" he adds.

Inker says it is "only rational" for stock owners to demand high returns "for taking that very unfortunate

return path."

Growth and low return

Investors have long been convinced that strong GDP growth in a particular country should correspond with strong stock growth. Inker says that has not been the case in the 20th century. Japan, for instance, had the strongest GDP growth during that 100 year period, yet its market returns were below that of the United States, Australia, and Sweden, all of which had much lower GDP growth.

Over the 30 years from 1980 through 2010 the same lack of correlation was noted

(Continued on page 2)

HIGH RETURNS ON STOCKS OVER THE LONG TERM ARE RATIONAL

(Continued from page 1)

between stock markets and GDP growth, he said.

This has occurred even though it seems to make sense that a growing economy would produce higher corporate profits, which would be reflected in higher stock prices.

This has not been the case, Inker concludes.

Why then do stocks offer higher returns? Because “workers invest to fund their retirements,” he says.

In that case, they demand a high return to compensate for the risk that their portfolios will decline precipitously just at the wrong time.

Inker notes that the internet bubble of 2000 was the worst point of overvaluation in the S&P 500’s history, and says the declines in valuation over the last 12 years “have been part of an essential healing process for U.S. equities.”

He says the idea that historic equity returns are no



Bear markets can't keep stocks down.

longer relevant is wrong. “Equities are very likely to be priced to deliver strong returns into the indefinite future,” he concludes.

RETIREES LOSE OUT ON SOCIAL SECURITY

Many retirees are claiming their Social Security benefits too early and losing out on their chance to maximize benefits, according to figures compiled by the Social Security Administration.

It’s latest statistics covering 2010 show that almost 44 percent of men took their benefits as soon as they were able to at age 62. Another 26 percent took benefits after 62 but before full retirement age. Only 13 percent took benefits at full retirement age and just a fraction waited until they could collect their maximum benefit at age 70.

Women claimed Social Security at about the same ages and rates as men.

A big haircut

This is a shame, because those who claim benefits early take a big cut in their monthly payments, locking in the lower benefits for the rest of their lives.

Every year past the early retirement age of 62 that a retiree delays benefits, the monthly payment grows by 8

percent. Just taking the benefits at full retirement age (for most of those currently retiring, around age 66) means an increase of 40 percent. Those who delay until the maximum age of 70 get as much as 80 percent more than the benefit they would have gotten at 62.

Social Security projects

the average life expectancy for men at 82 and for women at 85. That means claiming the largest possible benefit is important so that it can provide a hedge against inflation in old age, and a source of income that won’t dry up.

Only those who are in poor health or expect a short lifespan in retirement should consider early benefits.

So single workers in good health should delay benefits to as late as age 70, while those with health problems should consider taking it earlier.

Married couples have a tougher choice and more options, because their benefits are determined by each spouse’s earnings and they

must take into account their individual life expectancies.

In many cases, the higher earning spouse should delay benefits as late as possible in order to provide a larger survivor benefit to the lower earning spouse. Also, it

may be prudent for the higher earning spouse to file for benefits and then suspend them to age 70, allowing them to continue to grow, while the other spouse can begin taking a benefit based on the higher earnings spouse’s benefit.



The average retiree grabs Social Security as early as he or she can. By doing so they can lose out on tens of thousands of dollars in payments.

“Those who claim benefits early take a big cut in their monthly payments, locking in the lower benefits for the rest of their lives.”

RETAIL INVESTORS ARE MISSING THE BULL MARKET IN STOCKS

The financial crisis of 2008 apparently scared average investors so badly that they continue to flee from a strong, 3½-year stock market rally.

Even though the Standard & Poor's 500 Stock Index has gained almost 114 percent since its bear market low on March 9, 2009, the latest mutual fund reports show that U.S. investors keep pulling money out of stock mutual funds.

Morningstar Inc. says that as of July 31 investors pulled \$300 billion more from stock mutual funds than they put in over the prior three years.

Opting for no return

Meanwhile, the average investor's allocation to bonds has increased to 25 percent from its long term average of 16.9 percent, says The Vanguard Group, a large mutual fund company.

This is occurring at a time when the Federal Reserve and other major central banks are keeping short-term

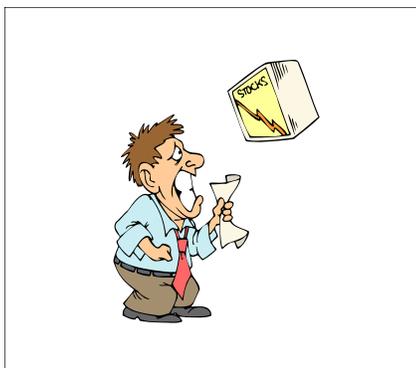
interest rates at nearly zero. Bond investors are earning next to nothing after inflation and taxes, and face the risk of losing principal if interest rates increase someday.

It is estimated that the average bond will lose 5 percent of principal for each 1 percentage point increase in rates. Yet bond funds have garnered \$734 billion in net contributions over the past three years, Morningstar says.

Fear mongering

The 24-hour news cycle and a Presidential campaign that emphasizes how slow the recovery from the 2008 recession has been contributing to ongoing investor fears.

This could pose a problem for those trying to build an adequate nest egg for retirement. If investors succumb to the threat of short-term market losses, they will miss out on the long-term, inflation-beating returns they need in order to get ahead.



Constant news coverage of the market's every wiggle can unnerve investors.

Also, scared investors often wait to get back into stocks until a raging bull market is underway. Unfortunately, that is often the worst time to invest as such manias can presage the next fall in stock prices.

Investors who wait for the next investment mania should take heed of the mistakes many made back in 1999 when Internet stocks logged immense gains, only to be beaten down to next to nothing during the subsequent three-year bear market.

“As of July 31 investors pulled \$300 billion more from stock mutual funds than they put in over the prior three years.”

COLLEGE DEFICIT, INSURANCE RISKS, & MORE

Families are beginning to save for college earlier than ever but their average accumulations are pitiful, shows a survey conducted by the College Savings Foundation.

About 45 percent of parents say they have saved more than \$5,000 toward college, up from about one-third who said they saved that amount in a 2009 survey.

However, an undergraduate education can cost as much as \$250,000 these days.

Some 57 percent of

parents said they started saving before their children reached age 5.

Risky business

Long-term care insurance is “one of the most risky products sold by U.S. life insurers,” says insurance ratings company Fitch Ratings. The perceived risk has caused several insurers to exit the business in recent years.

Insurers have been surprised at the number of buyers who maintain old policies.

Normally insurers ex-

pect 5 percent of policyholders to drop their coverage, but the lapse rate instead has been only about 1 percent.

Less life insurance

The great recession of 2008 didn't just cause stock prices to drop: many financially stressed households reduced or eliminated their life insurance, says The Swiss Re Group.

The average family with a wage earner under age 55 in 2010 had just \$32 in net assets and life insurance for every \$100 worth of protection their families needed, down from \$46 in 2001, it said.



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DON'T PAY EXTRA TO OWN A 'CLOSET' INDEX MUTUAL FUND

Active investment managers claim that their investment expertise will differentiate their performance from that of the stock market, gaining more when markets are up and losing less when markets decline.

But recent studies show that some of the biggest actively-managed stock funds are so closely correlated to the stock market that they are virtually indistinguishable from an index fund.

Index funds seek to replicate the results of the market they are indexed to: an S&P 500 Index fund, for instance, would try to duplicate the performance of the 500 largest U.S. stocks that make up the index.

An active manager, on the other hand, is supposed to be able to choose subsets



Indexed funds beat active funds but at a lower cost to investors.

of those stocks and to trade them in a timely manner in order to beat the index.

Morningstar Inc., the Chicago-based company that tracks mutual fund performance, says the some of the biggest actively managed stock funds have become "closet" index funds because they closely track the makeup, risks, and rewards of big U.S. stock indexes.

American Funds Growth Fund of America, for instance, has a very high correlation to the Russell 1000 Growth Index, which tracks the 1,000 largest growth stocks, it says.

The Fidelity Contrafund, T. Rowe Price Growth Stock Fund and BlackRock Equity Dividend Fund are not far behind, it adds.

In fact, the average large-cap stock fund is 99.7 percent correlated to its index, Morningstar says.

This should matter to owners of those funds, who pay 0.70 percent to 1 percent in fees to have their funds actively managed.

Instead, they could be paying 0.15 percent or less in fees to own an index fund that will have the same before-fee returns as the active funds, but a larger return after fees.