

CFA Insights & Outlook

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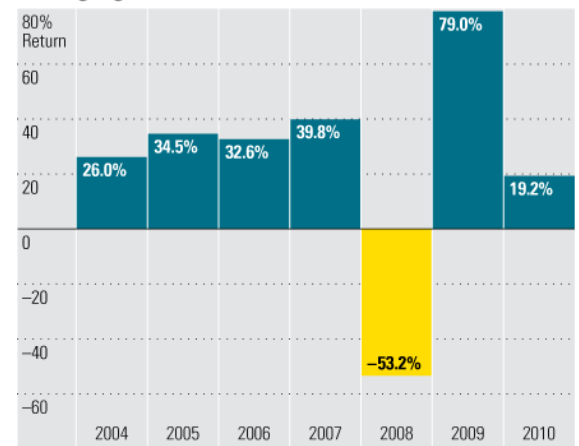
Vol. No. 1

Investment Updates

Overconfidence: False Perception

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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Another Option for Early-Retirement Withdrawals

The recent recession has hit older workers disproportionately. Older workers generally spend a longer time looking for jobs once they've lost them. The sad result is that individuals are tapping retirement accounts to stay in their homes and fund other living expenses, as well as to pay for major life changes such as relocation or further education.

IRA-withdrawal rules are particularly complicated, so this article will focus on one aspect of them in-depth: withdrawals based on the so-called 72(t) exception. Although it's almost never ideal to raid your retirement accounts prematurely, this type of withdrawal may be useful for people who need additional cash to carry them through a specific period in their lives--before they're eligible for a pension or Social Security, for example.

In a nutshell, the 72(t) exception allows individuals who are younger than age 59 1/2 to avoid the 10% early-withdrawal penalty for premature IRA distributions. (It does not help you circumvent any taxes owed on the IRA, however; just the 10% penalty.) To take advantage of 72(t), individuals must receive their IRA assets in what the IRS calls "substantially equal period payments" for a period of at least five years. The payments must continue until the age of 59 1/2 or until five years have elapsed, whichever is longer.

The net effect of that rule is that everyone using this exception will need to take withdrawals for at least five years, and younger folks will have to take distributions over many years. A 50-year-old woman, for example, would have to spread her distributions over 9 1/2 years, until she's 59 1/2. Meanwhile, a 57-year-old man who initiates 72(t) distributions would need to take the distributions for five years until he turns 62, well after he'd already hit the 59 1/2-year mark. If you've begun taking 72(t) distributions but later determine you want to stop, you'll owe the IRS the 10% penalties for early IRA distributions, plus interest. For that

reason, it's crucial to be sure that substantially equal periodic payments will work for you.

You don't have to liquidate all of your IRA assets to take advantage of 72(t); if you have separate IRA accounts, you can withdraw from some and leave others alone. It's also possible to reposition your assets in advance of a 72(t) distribution--that is, leave some money in an IRA to compound and grow while repositioning other assets in short-term securities for 72(t) distributions.

Furthermore, though the majority of people using this distribution method are doing so with traditional IRA assets, it's also possible to apply this distribution method to Roth assets. (This won't often be desirable, however.)

In general, 72(t) withdrawals will tend to make the most sense for people who need income during a certain period of time. And at the risk of stating the obvious, they'll also be best for folks who have an alternate source of retirement funding besides the amount that they're paying themselves through 72(t).

On the flip side, using this withdrawal method can be complicated and paperwork intensive. It won't make sense for those who need a lump sum to start a business or buy a vacation home because the whole point of 72(t) is that you're receiving payments during a period of at least five years. Nor will 72(t) usually make sense for Roth IRA holders, who have a lot more flexibility in taking withdrawals than do traditional IRA holders. Finally, those who leave their former employers at age 55 or after and have assets in their old 401(k)s can take penalty-free withdrawals directly from their accounts; rolling the assets into an IRA in order to facilitate 72(t) distributions wouldn't be necessary.

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A Quick Guide to Lagging Economic Indicators

Lagging indicators are economic indicators that lag behind the overall pace of the economy, and can confirm or deny the trend shown by leading indicators. Examples of lagging indicators include the average duration of unemployment, average prime rate, inventory-to-sales ratio, and the change in the Consumer Price Index.

The average duration of unemployment measures the average number of weeks an unemployed individual has been out of work, and is inverted to indicate a lower reading during a recession and a higher reading during an expansion of the economy. This statistic is measured by the Bureau of Labor Statistics on a monthly basis, and is seasonally adjusted to reflect the impact of predictable seasonal patterns. For example, retail businesses tend to hire more part-time employees during the holiday season. This is a lagging indicator because during an economic recovery, real wages increase first, followed by hours worked, and finally by an increase in hiring. This indicator is a good gauge for the overall business confidence sentiment.

The Consumer Price Index is released mid-month and measures the average rate of change month-to-month in the prices paid by consumers for a broad basket of consumer goods and services. This is the most widely-used measure of inflation today and is used as a guide by both Congress and the Federal Reserve to formulate fiscal and monetary policies. More specifically, the Core Consumer Price Index, which excludes the most volatile components of the index like energy and food prices, is used by the Fed to measure whether it is meeting its annual target inflation rate of 1.7% to 2.0%. For example, depressed CPI numbers coupled with high unemployment figures were key factors in the Fed's decision to start buying \$600 billion in Treasury bonds to boost investment and consumption rates at the end of 2010. Thus, investors who are interested in investing in government bond ETFs should take note of this indicator (prices of long-term bonds might go up, while yields would fall). This is a lagging indicator because it represents prices that

have already changed; announces that inflation arrived—one month ago.

The prime rate is what banks charge their most credit-worthy customers, mainly large corporations. Since Dec. 16, 2008, the Wall Street Journal determines this rate by polling the 10 largest banks in the United States, and will update the published rate when at least 7 of these banks have changed their rates. The prime rate is largely based upon the Federal Funds Rate set by the Federal Open market Committee every 6 weeks. The rule of thumb for the value of the prime rate is 300 basis points (3%) above the current fed funds rate, which is currently between 0% and 0.25%. This is a lagging indicator because the Federal Reserve sets this interest rate in response to economic growth rates, and to stimulate growth, the federal funds rate will be set low for a period after the economy is recovering. This is important to investors because many banks use the prime rate as a basis to price loan products such as student loans, credit cards, and car loans, and is a good indicator if one wants to invest in stocks or ETFs in the financial sector.

The inventory-to-sales ratio is reported by the Department of Commerce and measures how many months it would take to deplete the backlog of goods, adjusted for inflation. An increase in this ratio generally means that sales estimates were missed, and businesses will respond by postponing future orders and cutting production rates, resulting in a slowing economy. Beyond looking at the overall figures published monthly, serious investors should look at the numbers for manufacturers, retailers and merchant wholesalers since each sector has different sensitivities to an economic downturn.

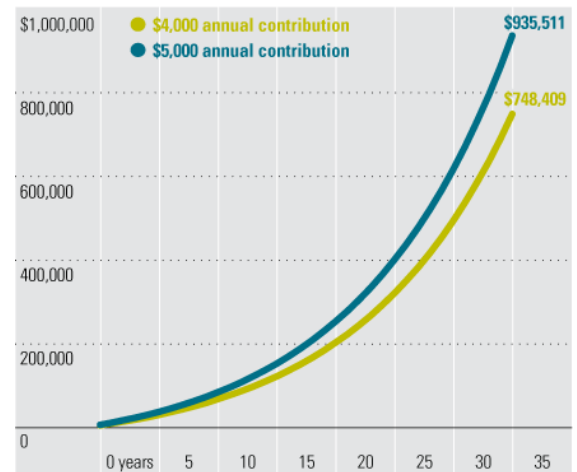
Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes.

Don't Forget to Raise Your IRA Contribution

In 2012, contribution limits for both traditional and Roth IRAs (individual retirement accounts) will remain the same as in 2011: \$5,000 a year for those 49 years of age or younger. If you are 50 or older, the maximum contribution is \$6,000. This limit can be split between a traditional and a Roth IRA. These annual contribution limits are imposed by the Federal Government.

The graph shows both a \$4,000 and \$5,000 annual contribution growing at a hypothetical 8% annual return. Notice the dramatic impact on the ending value of the portfolio. This may be a great time to re-evaluate your financial situation and increase your annual investment to your IRA. Even if you are unable to max out your contribution, any increase you can afford may help you reach your savings goals more easily in the long run.

Hypothetical Growth of Annual IRA Contribution



This is for illustrative purposes only and not indicative of any investment. Funds in a regular IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free as money withdrawn is not taxed. Penalties may apply for withdrawals prior to the age of 59 1/2.

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