Mentor Monthly Missive

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Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. 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 the original price of $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 interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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John S. Davis, CFP
President
john@mentoradvisers.com
630-530-1191
www.mentoradvisers.com

Meet our Wealth Managers

Mentor Capital Management Inc. was founded in response to the belief that a consumer's best interests are served when his or her financial planner is Fee Only. Advisors of Mentor Capital strive to provide objective, prudent and thoughtful advice to clients based on their personal goals and objectives.

John S. Davis is Mentor's founder, president and chief investment officer. A graduate of the University of Missouri, Columbia, he is a Certified Financial Planner licensee and a Registered Investment Advisory Firm Principal.

Daniel B. Carey is vice president of Mentor Capital and a member of its board of directors. A graduate of the University of Notre Dame, he is a Certified Financial Planner licensee and a Registered Investment Advisory Firm Representative.

What Is a Credit Score?

Ever wondered why your application for a credit card was declined? How the interest rates on your loans were determined? Or what those advertisements about getting your free credit report mean? All of these are related to one's credit score.

What is a credit score? It is a system that creditors, like banks, use to determine whether to extend credit to you, the consumer, based on the probability that you will repay the loan and make the payments when they come due. In addition, it is sometimes used to determine the interest rate on the loan. Generally, scores above 720 are considered excellent and you will qualify for most loans. If you have a score in the high 600s to 700s, you will qualify for most loans but not at the best interest rates. Consumers with scores below the mid-600s may not be able to qualify for credit cards loans, and even if they do, would have to pay unattractive rates. So what are the factors that determine your credit score and what steps can you take to improve it?

First, your payment history is the most important component of your credit score. If you have paid bills late or declared bankruptcy, this will lower your score. The best way to keep up with your monthly payments is to live within your means and only use credit cards if necessary. In addition, try to set up an emergency fund to protect you from unexpected expenses or changes in your income, like losing your job.

The second component looks at the amount you owe, or your debt-to-credit ratio. You should have some debt on your accounts to show that you are able to handle credit, but if the amount you owe is close to your credit limit, it is likely to have a negative effect on your score. In addition, some credit card issuers have been reducing lines of credit for customers who have not have any late payments, which will have the effect of increasing your debt-to-credit ratio so make sure to call your issuer to get this reversed if you are affected.

The length of your credit history looks at how long you have had a credit track record and considers the time since your accounts were opened and they were last used. Thus, even though you might have some inactive accounts, it is important not to close your oldest accounts especially if you have a relatively short credit history of less than 10 years.

Fourth, creditors look at whether you have inquired for new credit lately. Do not apply for too many accounts within a short period because it makes it look to creditors as though you are desperate for credit. If you need to make multiple inquiries for home or car loans, or for credit card applications, do it within a short period of time, between 14 to 30 days, so that it will be treated as a single inquiry. Speak to your financial advisor on the best ways to apply for new credit if you need to.

The last factor used in determining your credit score is the types of credit that you have. Try to have a good mix of different types of credit, including credit cards, car loans, and mortgages, which might take longer to establish depending on your current level of income. However, refrain from applying for too many credit cards because this may have a negative impact on your score.

To learn more about your credit score, go to Annualcreditreport.com and obtain a free annual credit report from any of the three major providers —Experian, TransUnion, or Equifax. You will not get your credit score with this free report but you will obtain qualitative information based on the five factors mentioned above, and learn whether you have any inaccurate information or unauthorized accounts. If you would like a more detailed report with your credit score, you can purchase the report from the providers.

Monthly Market Commentary

The S&P 500 has risen by almost 7% so far in 2012, causing investors to wonder whether the economy is slowly improving or whether this growth was merely the result of the January effect. Global economic news have generally been positive—it included China's slight drop in fourth-quarter GDP (as opposed to a plunge), a relatively quiet Europe, a positive U.S. employment/unemployment report, and the Federal Reserve's promise to extend low rates through 2014. Corporate earnings have so far been a mixed bag, and Morningstar economists believe that even as the U.S. economy continues to recover, earnings may continue to slow, especially for companies with significant exposure to China and Europe.

GDP: Real GDP grew by 2.8% in the fourth quarter, reflecting an overall positive trend in 2011. Consumer goods and inventories (GDP measures production, whether it is sold or simply sitting on a shelf somewhere) led this growth, contributing 1.3% and 1.9%, respectively, while government spending declined by 0.9%, mainly because of cuts in the defense budget. Morningstar economists believe that the 2.8% growth does not represent the new baseline for 2012, because the results were artificially boosted by unexpectedly good weather, the return of more normal auto production, inventory rebuilding, and shifts in retail employment.

Employment: Employment in January grew by an impressive 243,000 jobs, with 257,000 coming from the private sector, while the number of government jobs shrunk by 14,000. Although job growth rose across most sectors (only finance, information services, and government were down), the surprise came mainly from autos and durable goods, which benefited from favorable weather and large jumps in manufacturing and overtime hours, respectively. Retail also came as a surprise, as declines in seasonal hiring were offset by higher department-store and auto-showroom hiring, which boosted overall retail employment into growth territory.

Unemployment: The unemployment rate in January dropped to 8.3% from 8.5%. More important, this reduction came mostly from job growth as opposed to discouraged workers dropping out of the labor force or ceasing to claim benefits. To date, the U.S. economy has regained 41% of the 8.9 million private-sector jobs that were lost during the recession.

Manufacturing: The ISM Manufacturing survey reported better-than-expected numbers, indicating the third consecutive increase in the index and reflecting continued improvement in the auto industry. New durable-goods orders also rose much higher than expected in December, indicating that the manufacturing sector may be picking up steam and growing stronger.

Federal Reserve: The bold decision to keep interest rates low through late 2014 came as a surprise to many, and markets reacted positively to this unexpected news. Morningstar economists believe that continued low interest rates will actually start to pinch savers and hurt the personal income report in a meaningful way. Furthermore, this extended length of time does not lend any sense of urgency to either potential homebuyers or corporations considering large capital expenditures, further suppressing housing and private-sector growth. Given all the global economic uncertainty, there's almost no point in buying anything today when rates are guaranteed to stay low for the foreseeable future.

Despite the good employment news, the overall outlook remains far from optimistic. Rising prices and stagnant incomes put pressure on savings, while the low interest rate environment offers little yield as stocks continue to struggle. Although everybody is hoping for economic growth, the question remains—where will that growth come from?

Handling Sudden Wealth

If you have suddenly come into a large sum of money, whether it's a payout from an inheritance, the lottery, stock options, or a favorable verdict in a lawsuit, there are some important steps that you might want to take.

First and foremost, try to keep your bearings about you. Don't immediately quit your job; avoid any temptations to spend most or all of it on frivolous items. Be on the lookout for crooked financial operators who make offers that seem too good to be true, or friends and family who appear out of the blue with loan requests and business proposals. Don't feel that you have to invest your money right away. There's nothing wrong with letting it sit in the bank while you carefully consider your options.

No matter how you've obtained your windfall, there will be tax consequences. It is highly recommended that you consult with a tax lawyer to make sure you follow the right steps.

Before planning your long-term investment strategy, make sure you've taken care of some immediate needs. Establish an emergency fund (make it three to six months' worth of expenses), and if you've been carrying consumer debt like car loans or big credit-card balances, now's a great time to pay it all off.

Finally, consider how your windfall can serve you for long-term goals such as paying for children's education and your retirement. The questions are many. You might want to consult with a financial planner, who can help you figure out all the complicated variables and options.

MENTOR CAPITAL

John S. Davis, CFP
President

105 S. York Street
Suite 450
Elmhurst, Illinois 60126

john@mentoradvisers.com
www.mentoradvisers.com

Tel:630-530-1191