Improving Your Finances

3 Land Mines to Avoid in the Fourth Quarter

By Christine Benz | 10-13-16 | 05:00 AM | Email Article

As 2016 winds down, most investors can reflect on what has been a decent year for their portfolios thus far. With the exception of a few disruptions, such as a Brexit vote that caught global markets off guard this summer, equity markets around the world have been remarkably placid. And despite the increasing probability of a Federal Reserve rate hike later this year, bonds have held up just fine, too. The S&P 500 has gained roughly 6.5% for the year to date through early October, while the Barclays Aggregate Index has risen by about 5%. Performance strength has been exceptionally broad-based: Every single mutual fund category, save for healthcare sector funds and the oddball bear market group, is in the black for the year to date through Oct. 11. If current conditions persist, 2016 will go down in the books as a fine, albeit pretty unexciting, year.

But that's a big if, as the fourth quarter of 2016 holds the potential for more surprises than the typical quarter. Some investors are on tenterhooks about what U.S. election results could mean for their portfolios; the possibility of rising interest rates also looms large. At the portfolio level, investors could confront unwanted capital gains distributions from their mutual funds. That's a frequent issue following and even during periods of strong performance from stocks, but it has been exacerbated in recent years by the outflows from actively managed funds into passively managed alternatives.

None of these events is apt to create catastrophic, long-lived problems for investors' portfolios; in fact, hands-off investors who choose to ignore their portfolios during the fourth quarter will very likely come through just fine. (Mutual fund capital gain distributions would be the one issue I would suggest they keep an eye on, provided they have such funds in taxable accounts.)

But investors who keep a closer watch on the news flow and/or their portfolio's values may find themselves rattled by an unexpected turn of events during the fourth quarter. They shouldn't plan to upend their portfolios--that's a good way to turn short-term volatility into permanent capital impairment--but they should brace themselves for volatility and ensure their portfolios aren't taking any unanticipated risks.

Here are three potential trouble spots that investors could confront during the quarter, as well as strategies for ensuring those issues don't do a number on portfolios.

Election-Related Volatility

First, the good news: Historical market performance during presidential election years has been all over the map, suggesting that valuation and economic activity have been more influential than election results in determining the markets' return in such periods. The bad news: The market backdrop for this year's election season doesn't inspire a lot of confidence. U.S. corporate profitability is showing signs of slowing down; that, plus not-cheap equity valuations, makes the markets more vulnerable to a surprise result on Election Day than would be the case in an environment of vibrant economic growth and low market valuations.

And while a steady stream of polling data helps protect the market from being shocked by the election results, a surprise result in this year's election cycle is possible. After all, voters aren't just casting ballots on the presidency; they'll also determine which party controls Congress.

Thus, investors shouldn't rule out an Election Day shocker that could send stocks downward. It's a mistake to radically pare back on equities, but investors who have been letting their winners ride should consider rebalancing their portfolios to top up their positions in safer securities; the length and breadth of stocks' current rally suggest that many investors' portfolios are heavier on stocks than they intended them to be. This article discusses the case for trimming stocks if you haven't done so recently.

Interest-Rate-Related Volatility

Many market-watchers believe the Federal Reserve is likely to hike the Fed funds rate at its meeting in December; as of early October, the futures markets were pricing in a roughly 60% probability of a 0.25% interest-rate increase at that time. Not surprisingly, the bond market appears to have digested that possibility: For example, long-term government bonds, which are usually the most sensitive to interest-rate changes, have dropped by 5% over the past three months. Rate-sensitive equities have taken it on the chin, too, with both real estate and utilities skidding by more than 6% over the past three months.

That suggests that if the Fed does hike rates by the 0.25% that is widely anticipated, it wouldn't likely have a huge effect on investors' portfolios. More likely to cause volatility would be a larger-than-expected rate hike of 0.50%--or no rate hike at all. The former scenario would suggest that the Fed is seeing more signs of inflation than it had previously discussed, and would likely crimp prices on long-dated bonds while stoking investor interest in inflation-fighting investments such as Treasury Inflation-Protected Securities. If the Fed leaves rates alone, on the other hand, it could stoke worries about economic growth, sparking a sell-off in the equity market while driving up bond prices.

Those disparate outcomes underscore the virtue of maintaining a well-diversified portfolio and not betting exclusively on a single outcome--for example, shifting the whole of your fixed income portfolio into cash. But the fact that that a rate increase later this year could be followed by others later on also underscores the merits of getting to know just how interest-rate sensitive your portfolio's holdings are; this article discusses how to gauge your bond funds' interest-rate sensitivity, while this one delves into other asset types that could be affected by a rate hike.

Mutual Fund Capital Gains Distributions

The preceding two "land mines" could affect a broad swath of investors, but mutual fund capital gains distributions only matter those investors who own mutual funds--mainly actively managed funds--who hold those funds in taxable accounts (that is, not designated retirement accounts). Mutual funds must distribute to their shareholders any gains they've realized over the previous year; investors, in turn, must pay taxes on those capital gains, even if they haven't sold any shares. Funds begin publishing capital gains estimates in November and typically make their distributions in December.

The big, obvious mutual fund capital gains land mine to avoid is purchasing a fund right before it's about to make a distribution; the net effect of such an ill-timed

purchase is that the new investor would be on the hook for capital gains taxes even if she didn't enjoy any profits. One other potential land mine is pre-emptively selling a fund in an effort to dodge an impending distribution; that's often not advisable because the sale could trigger the investor's own (even larger) capital gains tax bill on his or her profit. However, it's worth noting that investors receive an increase in their cost basis when a fund makes a distribution that gets reinvested; thus, if a fund has been a serial distributor of large capital gains and an investor has been reinvesting them, the tax bill due at the time of sale might not be all that bad. (In essence, the capital gains distributions have forced the investor to "prepay" her taxes.) This article discusses the issue in greater detail, concluding that giving a portfolio a tax-efficient makeover may be less costly than investors think.

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