

# K M S

# Client Quarterly

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## Recovery, Reassessment, and Realignment

The element of surprise is a big factor for markets. At any given time the most widely shared view of the future is already discounted in securities prices, so it usually takes some kind of surprise to really move the ball. Early this year the prevailing view was unremittingly gloomy; global markets sank to their bear market's lows (one hopes). But the global economy did *not* fold its tent altogether; home prices did *not* plunge to zero; investors did *not* throw in all their cards.

The initial bounce off those lows has turned into one of the more impressive rebounds in market history. The run of statistics on the U.S. economy took a little more positive turn the past few months. The trade deficit has been running well below year-ago levels. Reported corporate profits for the second quarter were up 13.5% over late 2008. Productivity gains and moderating labor costs are contributing to a more constructive outlook.

Vehicle sales were picking up even before the Cash for Clunkers program kicked in, and auto production appears to be ramping up apace. Employment can hardly be said to be on the upswing, but the job losses have slowed. Home prices appear to have found some footing, and consumer net worth actually had turned up heading into the third quarter.

The bigger story may be the global recovery's *overseas* leadership. Several important foreign countries reported positive growth in gross domestic product (GDP) for the second quarter, including Singapore, China, Korea, Indonesia, Japan, Germany and France. This is a break from the long-established pattern of the U.S. economy pacing the world out of economic troughs. Its importance is magnified by the multi-year shift in relative shares of global GDP.

The secular trends suggested below are not new,

Source: UMB Asset Management	World-Share of GDP		Average
	2004	2009	Growth Rate
United States	28.0%	25.5%	3.68%
Other Advanced Nations (x-US)	50.6%	43.8%	2.63%
Emerging & Developing Nations	21.4%	30.7%	13.50%
Africa			11.87%
Central Europe			9.03%
Developing Asia			16.78%
Western Hemisphere			10.09%

## New "Frontiers" for Global Equity Investors

Foreign stocks were still seen as adventurous for individual investors when they were first covered in these pages 20 years ago. By 1992 the discussion had turned to emerging markets, especially the "tiger" economies of Korea and Southeast Asia. China's transition into a major economic power warranted frequent updates. In 2004 the *Quarterly* covered the rise of India's retooled economic policies and its role in the global tech revolution, and in early 2005 we turned to the economic transformation of Eastern Europe. A bull market in commodities spurred resurgent interest in Russia, Brazil, and other resource-rich countries.

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but they appear to have accelerated in recent years. Progress and opportunity across developing economies have been themes of this publication for nearly two decades. Combined GDP for those nations now exceeds that of the U.S., and their prosperity increasingly affects that of the "developed" world.

Despite better economic news and recent market gains, recoveries don't run in a straight line. The U.S. employment picture may be cloudy for a considerable period. The federal government and a number of states find themselves in considerable fiscal distress. And the rally that has boosted the Standard & Poor's 500 Index by more than 50% in six months also has taken market ratios, such as price-to-earnings and price-to-book-value, back toward the upper end of their historic ranges. It's harder to make the case that stocks are "cheap" by those traditional valuation measures.

Seat-of-the-pants market timing often erodes long-term results. Investors who held their ground through the darkest months of 2008 and early '09 have enjoyed the sharp rebound. But the future is as uncertain as ever. It is usually more constructive to review the risk profile of one's portfolio in the glow of recent gains rather than under a cloud of losses. If you found the turmoil of last fall and winter to be terribly unsettling, it may be time to check in with your KMS Representative to review the shape of your current allocation. §

**New Frontiers...** (continued from page 1)

So what's next for thrill-seeking investors?

You may be hearing about "frontier" markets: promising countries with much smaller, less liquid capital markets. In late 2007 Morgan Stanley Capital International (MSCI) launched a Frontier Markets Index that now lists 22 countries across four regions.

**The "Frontiers" of Equity Investing**

**Eastern Europe**

Bulgaria Croatia  
Estonia Khazakhstan  
Lithuania Romania  
Serbia Slovenia  
Ukraine

**Middle East**

Bahrain Kuwait  
Lebanon Oman  
Qatar Jordan  
UAE

**Asia**

Sri Lanka Vietnam

**Africa**

Kenya Mauritius  
Nigeria Tunisia

Any of these may strike one as a dicey destination for capital, but as a group they've been generating some of the world's highest economic growth rates. Yet they feature valuations significantly discounted from developed markets, largely due to the perceived risks and notable inefficiencies related to infrastructure, political systems, labor markets, and taxes.

Frontier markets may continue to benefit from the over-arching trends of globalization, foreign direct investment, rising worker productivity, and progress up the value chain from agriculture and cottage industries to more sophisticated manufacturing and services. From 2003 through 2007 their collective GDP grew at a 6.5% rate, topping the 5.8% for emerging markets and much stronger than the 3% average for developed markets.

These markets may also enhance portfolio diversification. MSCI's Frontier Markets Index has shown a fairly low correlation to the MSCI EAFE index of more mature, non-U.S. equity markets. Correlations to the Standard & Poor's 500 and the Dow Jones AIG Commodity Index have been even lower.

Believers in the long march of global progress may be drawn to these new frontiers, but they should not expect a smooth ride. If past experience with emerging markets is any indication, there will be periods of unnerving upheaval, manic rallies, and wicked corrections. Frontier markets represent a *long-term* play for a careful commitment of *risk* capital. §

**SEC Gives a Nod to the "Summary" Fund Prospectus**

Securities regulators and mutual fund companies tried for years to come up with a mutually acceptable "summary" or short-form prospectus. Many investors view the standard fund prospectus as a daunting thicket of information laden with legalese and a laundry list of required disclosures. It's all well worth reading, of course, but not always the most *efficient* way to flesh out the key factors bearing on an investor's decision.

Late last year the issues were finally ironed out, and the Securities and Exchange Commission voted to *require* funds to provide a standardized summary. That summary must provide a concise overview *in plain English* of the key information an investor would need to make an informed decision. Don't look for a prediction on where the market is headed, but the summary should outline the fund's investment objectives, strategies, risks, and costs; information on the portfolio's managers; procedures for buying shares; tax considerations; and compensation to intermediaries.

As funds issue their annual prospectus updates, the new summaries are appearing with those documents. And the summary itself satisfies prospectus *delivery* requirements as long as the full prospectus and other specified information are available online in keeping with certain guidelines. Investors can always request a hard copy of the full prospectus, but online delivery has become increasingly common as the push to reduce paper proceeds.

Ideally, as more folks use online access, fund companies will save some of the millions they've routinely spent on printing and mailing prospectuses, and those savings will be shared with investors through lower fees. Hey, it could happen! §

**Performance Summary: Major Mutual Fund Categories\***

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested				
	YTD	--- Annualized through Sept. 4, 2009 ---			
		1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	16.0%	- 14.7%	- 5.7%	0.4%	- 0.7%
Mid-Cap Stocks (Core)	23.0	- 16.2	- 5.2	2.2	4.8
Small-Cap Stocks (Core) †	19.2	- 16.9	- 6.2	1.7	5.9
Foreign Stocks †	23.5	- 10.5	- 4.7	5.8	4.0
Emerging Market Stocks †	51.8	- 6.0	2.5	14.5	10.7
Flexible Portfolio	14.4	- 5.3	- 0.6	4.1	4.1
General Bond	7.2	2.3	3.6	3.8	6.2
Int'l Income (non-U. S.) †	8.1	9.6	6.4	5.6	6.1
High-Yield Taxable Bond †	32.2	0.5	1.3	3.4	4.0
General Municipal Debt	14.2	3.0	2.1	2.9	4.2

\* Source: Lipper, as reported in the *Wall Street Journal*, September 5, 2009.

**Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose greater risk and price volatility than securities of larger, well-established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

## Income Limit for Roth IRA Conversions Comes Off in 2010

As 2010 approaches you may hear some chatter about the new opportunity for higher-income earners to convert traditional IRA assets to a Roth IRA. Here are the key bullet points of that discussion, plus a few words of caution.

- Starting in 2010 and beyond, anyone with an IRA or other retirement plan assets can convert to a Roth IRA, *regardless of income level*. Currently conversion is only available if a household's modified adjusted gross income does *not* exceed \$100,000.

- Apparently the government wants to get the ball rolling, so for conversions completed in 2010 *only*, the resulting taxable income may be deferred and divided equally between tax years 2011 and 2012.

- If one's IRA assets are still hurting from the bear market, a conversion may be timely; the smaller conversion will trigger less tax, and the portfolio will be positioned for recovery in a vehicle that, at least under *current* law, provides for future tax-free gains.

- Looking toward retirement, it's also worth noting that withdrawals from a Roth IRA are not included in the income calculation to determine the taxable portion of one's Social Security benefits. Distributions

from Traditional IRAs *are* included in income and can increase the taxability of Social Security benefits.

- Unlike with other IRAs, a Roth owner is *not* required to take withdrawals after reaching age 70½ or at any other time during his life. The Roth IRA passes to beneficiaries income-tax-free (estate taxes may apply), and beneficiaries receive withdrawals tax- and penalty-free provided they meet certain requirements.

**In most cases converting from a traditional IRA to a Roth has a big drawback:** payment of substantial tax dollars that could otherwise stay invested. Unless one has a particular window of opportunity – e.g., a year in which taxable income is expected to be very low – converting is a tough call. Consider:

- Current law *could* change. Federal budget pressures are rising rapidly, and upper-income taxpayers make an inviting target politically. Remember that for nearly 50 years, Social Security benefits were tax-free too. After all, retirees pay into the system with “after-tax” dollars. But in the early 1980s taxability was introduced on up to 50% of retiree benefits, and that maximum was bumped to 85% in the early 1990s.

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## Mixing It Up in Fixed Income, Once Again

It was March, 2003. Stocks were bumping along the bottom of a protracted bear market, and money market yields were at their lowest point ever as the Federal Reserve tried to push on the string of *that* “jobless recovery.” Sound familiar? That Spring's *Client Quarterly* featured essentially the same table you see below, but covered the period 1996–2002. It conveyed a similar message: Diversification can play a constructive role in fixed income as well as equity investing.

Investors face a similar dilemma today. Many are hesitant to raise their stock market exposure after the dizzying rollercoaster ride of the past 20 months. But hunkering down in money market funds looks like a zero-sum game. Is it safe to step out for a little yield without having your head handed to you?

Of course past performance is not indicative of future results. And as everyone relearned in 2008, bonds can take their lumps too. Sooner or later interest rates rise or fall; the dollar strengthens or weakens further; corporate defaults subside or worsen. Concentrated bets tend to concentrate risk.

As we noted six years ago, you probably do not need a half-dozen funds to achieve broad diversification in fixed income. Some funds have the flexibility to invest across multiple sectors and adjust allocation according to the manager's view of economic developments here and elsewhere. That story does not appear to have changed much. §

Taxable Bond Funds: Blending Risk and Return								
Bond Fund Category	TOTAL RETURN (Dividends & Gains Reinvested) -- 6.7 yrs							
	2003	2004	2005	2006	2007	2008	thru 8-09	Ann'l'zd.
Short-term Bond	2.5%	1.6%	1.4%	4.0%	4.3%	- 4.2%	7.4%	2.5%
Intermediate Bond	5.1	4.0	1.8	4.2	4.7	- 4.7	10.5	3.8
Long-term Corp.	8.8	6.4	2.2	4.5	3.1	- 3.7	11.9	4.9
Long-term Govt.	1.7	7.4	<b>6.1</b>	0.2	<b>9.7</b>	<b>27.7</b>	- 11.4	5.6
High Yield	<b>24.3</b>	<b>10.0</b>	2.6	<b>10.1</b>	1.4	-26.4	<b>32.1</b>	<b>6.5</b>
International Bond	13.8	9.0	- 3.3	5.5	7.3	- 1.6	10.3	6.0
<b>Blended Averages:</b>	<b>9.4%</b>	<b>6.4%</b>	<b>1.8%</b>	<b>4.8%</b>	<b>5.1%</b>	<b>-2.2%</b>	<b>10.1%</b>	<b>4.9%</b>

\* Source: Morningstar.com

## Are These IRS Dudes Cool, or What?

It may be just a matter of time before some auditor from Internal Revenue will be soliciting your “friendship” via *FaceBook*. Meanwhile the IRS has launched a YouTube video site and an iTunes podcast site to share information on the 2009 American Recovery and Reinvestment Act (ARRA)... *really*.

The IRS YouTube channel ([www.youtube.com/irsvideos](http://www.youtube.com/irsvideos)) debuted with seven ARRA videos in English with ASL signing, and eight in Spanish. If you are among the millions of taxpayers who find IRS forms and directions to be “written in Greek,” these videos

may help. The first set includes a primer on using the new IRS Withholding Calculator (watch with close friends). Also featured are the \$8,000 first-time home-buyer’s credit, the sales or excise tax deduction on new car purchases, and expanded credits for education and energy conservation. (*OMG!*)

If you have an iTunes account, you can listen to IRS podcasts about ARRA’s tax credits (perfect for your “workout” playlist). If you do *not* have an iTunes account (*What?!*), you can still get in on all the listening enjoyment via the Multimedia Center at [www.IRS.gov](http://www.IRS.gov). But don’t delay, because the really *cool* kids will be all over this stuff before you know it. §

## Income Limits for Roth IRA Conversions... (cont’d from page 3)

- If a Roth conversion turns out to be not so advantageous for some reason, it can be undone (“re-characterized”), but only up to one’s tax-filing deadline (plus extensions) for the year of conversion. If the investments take a substantial hit *after* that window closes, one will have paid taxes on more assets than subsequently remain in the Roth IRA.

- Taxes paid on a conversion *do*, by definition, reduce the amount of long-term investment capital available to help secure your financial future. The conversion *may* result in future tax savings, but the *forfeiture* of that capital is immediate and unequivocal.

If you think you may want to take advantage of the new flexibility for converting to a Roth, check with your KMS Representative or tax advisor. It can be advantageous to convert early in the tax year and maximize the time frame for recharacterizing if your circumstances change. §

### For additional information on any of the items listed below, please call:

or the KMS Seattle Home Office:  
**(206) 441-2885, ext. 0**

- Mutual Funds, Unit Investment Trusts, & Exchange-traded Funds
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- IRAs and Tax-qualified Retirement Plans
- “529” College Savings Plans
- Insured Certificates of Deposit