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As the World... Rotates

One of 2013's early investment buzz phrases was "The Great Rotation" – the idea that investors were poised for a major turn away from bonds and toward stocks. Commentators have debated whether it would really happen, was already under way, or had come and gone.

U.S. equity mutual funds and ETFs did pull in a net $40.3 billion in July, eclipsing the old record of $34.6 billion dating back to February, 2000. And bond funds have seen redemptions as a long-awaited kick-up in yields produced negative total return on second quarter statements for many bond fund holders.

Market watchers continue to parse every utterance from any Federal Reserve governor to discern the timing and extent of the tapering of its bond purchases. Persistent, albeit deliberate, economic growth may well prompt the Fed to push the Fed Funds rate up from zero.

Of course a rotation of some consequence *has* already occurred. As shown below, the broad bond market outperformed stocks for the past 15 years (ending July 31st). But for the trailing *ten* years, stocks regained their edge and even led for the five years that commenced with the 2008-09 sell-off.

This is hardly an argument for dramatic changes in allocation to chase higher returns. Rather it's a reminder that some meaningful results can be had by those who sustain a well-planned strategy through tough times, holding their own when others are rotating, revolving, pivoting, or whatever else the latest *buzz* might suggest. ■

The Great Rotation That *Was*

Broad Asset Category	Annualized Total Return * Periods ended 7-31-2013			
	15 years	10 years	5 years	3 years
Stocks[1]	4.7%	7.6%	8.3%	17.7%
Bonds[2]	5.5%	4.9%	5.2%	3.2%

[1] Standard & Poor's 500 Index
[2] Barclay's US Aggregate Bond Index
* *Source:* Bloomberg

Even Uncle's Credit Rating Is on the Mend

This fall marks the fifth anniversary of some of the darkest days of the 2008 financial crisis. That September 15th, the venerable firm of Lehman Brothers filed for bankruptcy, triggering a 5% one-day drop in the Standard & Poor's 500 Index. By October 10th the S&P was down *another* 25%, just the midpoint of a slide to its low close March 9, 2009. As the lads from Liverpool might say, "... that was yesterday, and yesterday's gone."

Gone perhaps, but not forgotten. So it's nice to hear a little good news. For instance, *Institutional Investor* latest semi-annual assessment of global sovereign credit worthiness showed some improvement. Credit scores for 179 countries reviewed averaged 44.6 on a scale of 100, still shy of the pre-crisis high of 48, but moving in the right direction. And the big gainer among developed nations was the good old USA, rising 2.5 points to 91.3 and jumping from 12th to eight place.

You may recall that just two years ago Standard & Poor's was downgrading U.S. Treasury debt from AAA to AA+. That was near the end of a political tussle over the federal budget and raising the government's debt ceiling. Stocks were taking a hit; pundits were predicting higher borrowing costs for Uncle Sam; and the feuding politicos were passing the budget morass to a "blue ribbon" commission. Over the ensuing two years stocks mostly rose, federal borrowing costs mostly fell, that blue ribbon commission was mostly ignored, and the deficit has been cut in half. Go figure.

By the way, if you wonder which countries garnered a higher credit score than the U.S., the top seven are Norway, Switzerland, Sweden, Canada, Germany, Singapore, and Finland. But hey, we're right on Finland's heels. With another year of gridlock in D.C., maybe we can pass the Finns and make Singapore sweat a little. ■

Some Are Heading for the Frontier

Four years ago the *Quarterly* discussed some of the more exotic outposts of the investment world known as frontier markets. That lightly traveled sector went on to post strong returns in 2010, a modest pullback in 2011, then another solid advance in 2012-13. Now it's attracting a little surge of interest despite the risk aversion that has ruled so many investors in recent years.

In an odd divergence, the MSCI Frontier Markets Index had gained 15% through August while the Emerging Markets Index declined 11%. But the frontier is still a tiny corner of the investing universe, so it doesn't take much to move the Index. The 141 companies on that list total just $125 billion of market cap – a third the value of Apple, Inc. The same shallow-pool dynamic that has helped lift frontier stocks lately can be a key risk when sentiment turns

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A Familiar Complaint, but Now More Solutions

Ten years ago the *Quarterly* asked if one can have *too many* choices, especially when it comes to investing in a 401(k) plan. In a recent survey conducted for Schwab Retirement Plan Services more than half of the respondents said their plans' investment options still present a more confusing picture than their choice of health care benefits.

Unlike a decade ago, many retirement plans now offer some pretty effective antidotes to paralysis by analysis. Most prominent are the target date funds which proliferated after the Pension Protection Act of 2006. Typically, a target date portfolio holds a group of underlying mutual funds with an allocation geared to a specific retirement date. The idea is for the fund to gradually adjust its portfolio, defining a kind of "glide path" to that target date.

Allocations will represent the best thinking of the fund manager, and different offerings tied to the same target date may be allocated quite differently. For example, suppose you're looking at retirement in about a dozen years (2025). According to Lipper, Mixed-Asset Target 2025 Funds averaged total return of 11.6% for the year ended August 23rd. But the top five funds in the category returned from 15% to 17.5%, while the bottom five ranged all the way from 1.5% to 8%.

It may be more telling to look back *five* years, a time frame that picks up the worst of the financial crisis sell-off. That five-year average for Target 2025 Funds was 5.3% annualized, with the period's top performers in the 6.0% – 7.4% range, while the laggards annualized in the 3.0% – 4.5% range.

Those differences may get more pronounced as a specific target date approaches. Some managers allocate around the idea that the retiree will continue to hold the fund well beyond retirement, perhaps for a couple decades or more. Others steer toward a markedly more conservative allocation as the target date nears. The approach a particular fund favors should be clarified in the prospectus and other supporting information.

In less than a decade target date funds have gained traction as a staple of the nation's retirement savings scheme. They've garnered a half-trillion dollars in total assets and now rank second only to U.S. large-cap stock funds as a current choice for plan participants' self-directed dollars. In many plans they are used as default receptacles for contributions on behalf of participants who don't specify a choice. Best to have some idea of how they work. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru Sept. 5, 2013 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	20.5 %	15.4 %	7.4 %	6.7 %
Mid-cap Stocks (Core)	25.3	16.3	8.6	8.4
Small-cap Stocks (Core) †	26.0	17.3	9.1	8.8
Foreign Stocks (Multi-cap) †	19.4	7.8	3.6	6.9
Emerging Market Stocks †	3.8	0.1	2.7	11.4
Natural Resources	17.4	11.9	1.9	12.1
Real Estate Related	– 1.8	11.9	4.5	8.4
Flexible Portfolio	5.0	7.1	5.3	6.3
General Bond	– 1.1	4.3	6.1	6.1
Int'l Fixed Income †	– 4.7	1.6	4.5	5.2
High-Yield Taxable Bond †	6.8	8.5	9.1	7.5
General Municipal Debt	– 5.4	2.2	3.7	3.6

* Source: Lipper, as reported in the online *Wall Street Journal*, September 6, 2013.
Past performance is NOT indicative of future results.

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, 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.

A Showdown in Motown

This hasn't been the best year for municipal bonds. If the general nervousness over rising interest rates wasn't enough, investors were faced with this summer's bankruptcy filing by Detroit, the largest U.S. municipality ever to take such a step. And there was the city's suggestion that its general obligation (GO) bonds should be considered *unsecured* debt, perhaps subordinate to such obligations as unfunded retirement benefits for city workers.

Conservative investors traditionally favored GOs for the backing of the issuer's broad taxing authority. But some muni bond professionals have expressed a current preference for revenue bonds, especially those supported by dedicated payment streams from such essential services as water and sewer systems.

The municipal market will digest the necessary restructuring of Detroit's debt along with a smattering of other troubled issuers. While the tax-exempt securities pool is awfully broad, it is not very deep for many issues. Selectivity and diversification are critical, as are skillful trading and low transaction costs.

With those factors on your side, muni yields do compare favorably on a taxable equivalent basis with high quality corporate bonds and Treasury securities. Well-managed portfolios of tax-exempt bonds continue to be a staple for conservative, tax-sensitive investors. ■

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Reviewing Those Variable Annuity Guarantees

For more than a decade investors have been attracted to an array of enhanced death benefit and withdrawal guarantees in variable annuities. Volatile markets, economic turmoil, historic low interest rates, and demographic trends made income security a dominant concern. Insurance companies appeared to have found a big market for what they do best – insuring stuff. But pricing the risks turned out to be kind of tricky.

The financial crisis and market sell-off of 2008-09 greatly expanded the obligations inherent in those guarantees while shrinking the variable annuity account values from which an insurer could draw the contract fees designed to compensate for that risk. Investors had cut a good deal for themselves by securing those guarantees in the years leading up to the financial crisis. Some carriers exited the variable annuity business and started looking at ways to rein in their liabilities.

After all, a variable annuity is a contract between the insurer and the owner (investor). Both parties can make changes, including the investor's option to walk away, usually subject to surrender charges for at least a few years). Some insurers are exercising contract prerogatives such as restricting the investment choices allowed in conjunction with a guarantee. Others have offered to add money to contractholders' accounts in exchange for canceling a guarantee feature.

A diverse array of guarantee benefits is still available to variable annuity buyers, generally at somewhat higher charges than were typical several years ago. If you already own a VA with guarantees in place, it is important to review the contract with your advisor from time to time. Basic elements of such a review include the following:

Is the guarantee currently in or out of the money? This may or may not be easy to determine, but it's basically a question of whether one could comfortably secure a comparable benefit in today's marketplace with the net (after-tax) proceeds from liquidating the contract.

Is the guarantee still relevant? Changes in one's health, income, or estate planning may change the objectives that drove the selection of a given guarantee several years ago.

Is the investment allocation still appropriate? In combination with the considerations above, there may be strategic reasons to be more or less aggressive with the investment choices inside the contract.

Your KMS Advisor can help evaluate these issues in the context of your total investment holdings and objectives. And please note: The guarantees referenced above look to the claims paying ability of the insurer. ■

A Mobile Workforce, Now *and* Then

For years we've heard that the typical worker will change jobs, even careers, much more often than used to be the norm. So we shouldn't count on long, secure tenure with one employer, culminating in a gold watch and a comfortable pension.

The latest Census Bureau data question whether those facts of life actually represent much of a change. The midpoint employment duration for wage and salary workers was actually a little longer in 2012 (5.4 years) than in 1983 (5.0 years). Male workers did show *slightly* shorter average tenure in their jobs compared to 30 years ago, but that was more than offset by markedly longer employment duration for women.

The Census study also suggests that those "career" jobs back in the "good old days" were no more common for most workers then (whenever that was) than they are today. Apparently, frequent employment change has been typical over the course of many decades.

What does it all mean? Well, we might be a little more skeptical of those breathless pronouncements of revolutionary change – economic, demographic, etc. Many of life's patterns and realities are pretty familiar, while our recall of the distant past can be quite selective and just a little fuzzy. ■

More (Baby) Food for Thought

While we're pricking balloons of received wisdom, how about the long-standing story of falling birth rates in the developed world? A special report by the *Bank Credit Analyst* challenges that one as well.

Citing research by the Max Planck Institute for Demographic Research, the *BCA* believes projected birth rates for key countries have been understated, due to the trend of women giving birth at older ages. Established statistical methods assume that child-bearing numbers for women in their 20s predict their later birth count based on the patterns for prior cohorts. But average ages of women's first births have been rising across the developed world.

The financial crisis and recession appear to have delayed household formations and pregnancies. But these prospective parents are an echo of the original baby boom, i.e., there are lots of them. And in another trend change, developed economies now show a positive statistical correlation between household income and fertility.

So far the 2010s do show a pickup in the birth rate after five straight decades of decline. Of course the decade is still young, but who has kids and how many they have are among the most fundamental inputs to the rise and fall of economies. For truly long-term investors, this should be worth watching. ■

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negative. All markets cycle, and liquidity always affects the amplitude of gain and loss.

With that caveat in mind, what does the frontier look like, and what's the main appeal? Along with the quest for growth, price/earnings ratios compare favorably to the stocks of the S&P 500 Index. Of course some risk premium would seem to be in order.

Financial and telecom players represent about two-thirds of the MSCI Index, and these are the kinds of enterprises that figure to participate broadly in economies that are building up and out. Industrials, consumer staples, and energy are also well represented.

Top countries in the Index are Kuwait, Qatar, Nigeria, United Arab Emirates, and Pakistan. If that isn't exciting enough, there's a dollop of exposure to such places as Kazakhstan, Mauritius, Oman, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, and Vietnam.

By the way, the folks who manage the MSCI Indices note that next spring Kuwait and UAE are expected to graduate from the Frontier Markets and join those old fogies in the Emerging Markets Index (investment mainstays like Russia, China, Brazil, etc.). The play for higher growth across these sectors may hold promise, as long as it's not money you'll need for anything else any time soon. ■

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2001 Sixth Avenue, Suite 2801
Seattle, WA 98121

Maybe Folks *Are* Taking the Longer View

Our previous issue took a quick swipe at the short-termism of cable TV's financial news shows, noting that they are "a part of the entertainment world designed to profit from, rather than mitigate, the fear-greed cycle." But it looks like some investors are changing the channel.

The news site ValueWalk reports that the June ratings quarter for CNBC, the leading financial and market news station, was its worst since 1994 among 25-to-54-year-olds. CNBC still leads the financial cable news competition, but some of its most popular offerings geared to individual investors saw the steepest declines in viewership.

Advisor Carl Richard, writing in *The New York Times*, sees that as positive, noting that if an investor in the Standard & Poor's 500 Index from 1950 through 2012 had checked his account just once a year, he would have been pleased by about 78% of those snapshots. Checking day to day would only have brought a smile 53% of the time. Of course the ideal interval for checking one's account is probably somewhere *between* those two extremes. ■

For information on our investment services, please contact:

Your KMS Representative

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