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Investors Welcome Back the "Long Bond"

The credit markets recently welcomed back an old friend, the 30-year U.S. Treasury bond. The Feds auctioned $14 billion worth on February 9th, the first new 30-year issue since late 2001. Investors snapped it up at a yield of 4.53%, and the bond rallied from there to trade briefly at yields just below the current 4.5% Fed Funds rate.

The return of federal budget deficits in recent years played a roll in bringing back the long bond, but the more salient factor is the current shape of the yield curve. When 30-year bond auctions were suspended in 2001, yields were higher across the board, and the curve was steeper. The Treasury had to pay measurably more to borrow 30-year money than 10-year money. Today there's almost no difference. At February's quarterly refunding the Treasury also auctioned $13 billion of 10-year notes at a yield of 4.54%.

Treasury is seizing on the same market conditions that have allowed homeowners and major corporations to lock in long-term financing at historically low rates. One way to think of the federal government is as the legal, finance, security, and administrative arm of a big diversified enterprise called USA Inc. Funding its activities averages about 20% of the enterprise's overall production. About 18% is assessed from production in the form of taxes, while the other 2% is borrowed from lenders here and abroad. That gap between taxes and loans tends to wax and wane (with notable time lags) according to the strength of USA Inc.'s overall operations and the government's spending needs.

Over the course of many decades and major changes in its "business," USA Inc. has sustained a reputation for effective management of its (national) debt. By the end of World War II, federal debt held by the public exceeded the nation's gross domestic product (GDP). Today it's about 37% of GDP, near the average of the past four-and-a-half decades.

Financial asset holdings across the world's developed nations total well over $50 trillion, so it's not too surprising that global investors have willingly anchored $4.5 trillion in highly liquid, historically reliable U.S. Treasury securities. At some juncture USA Inc.'s lenders may become more skeptical of its prospects and demand commensurately higher yields. Judging by the credit market's reception for return of the "long bond," that hasn't happened yet. §

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Pension Plan Sponsors Tend to Chase Performance Too

According to a recent academic study, the folks who hire and fire investment managers for large pools of assets show some of the same performance-chasing behavior that individual investors are often criticized for.

Last year a pair of economics professors, Amit Goyal of Emory University and Suni Wahal of Arizona State, released a study of selection and termination of investment managers by corporate pension plans, unions, foundations, and endowment funds over the decade 1994-2003. They found that those institutions typically hired managers who had shown large positive excess returns in the *preceding* three years. But on average, those managers did *not* deliver positive excess returns in the years immediately *following* their engagement.

On the flipside, managers typically were terminated after a period of underperformance, and then produced excess positive returns for somebody else. Had the decision makers stuck with the fired managers, their excess returns on average would have bettered those delivered by the replacement managers.

The study examined the actions of more than 4,000 plan sponsors and endowment trustees, including nearly 10,000 hiring decisions involving about $730 billion in assets, and 1,000 firing decisions affecting $110 billion. Commenting on the study for *InvestmentNews*, William Atwood, executive director of the Illinois State Board of Investment, noted, "On an intuitive basis that's certainly a legitimate concern, [but] on a staff level, it's hard to look beyond the one-, three-, and five-year performance numbers." Indeed it is.

So maybe the "small" investor actually has an

(continued on page 4)

Tax-Exempt Bonds... Forgotten but Not Gone

With global equity markets, commodities, and real estate hogging the spotlight, it has been easy to overlook a quiet investment asset like tax-exempt municipal bonds. Some market strategists suggest giving them a fresh look for the conservative portion of a portfolio,.

Quality, intermediate-term municipals have been sporting about 85% of the yield on comparable-maturity Treasury securities. At longer maturities, nominal yields on tax-exempts actually have been running *higher* than Treasurys, making their taxable-equivalent yields especially attractive. Three years into an economic recovery, many states and municipalities are enjoying robust revenues, so credit risk appears modest.

If general interest rates rise, municipal bond prices could take a hit. But the muni market has a tradition of calling its own tune, and Americans' abiding interest in tax-exempt income offers some insulation from the forces that drive global capital. Whether munis make sense for you depends on several issues including your federal (and state?) income tax bracket. Your KMS Representative can help you review those issues. §

Update on Retirement Plan Contribution Limits for 2006

In 2001 Congress passed a multi-year series of increases in contribution limits for tax-favored retirement accounts. For 2006 a couple of key limits reach the apex of that process.

This year, participants in 401(k) and 403(b) plans can defer up to $15,000, and those who are 50 or older can defer up to another $5,000 in "catch-up" contributions. The *aggregate* limit (employee salary deferral plus employer contribution) rises to $44,000. The $5,000 catch-up is available in *addition* to other applicable limits.

Of course there's still that old standby, your Individual Retirement Account (IRA). The contribution limit to a traditional or Roth IRA holds at $4,000 for 2006. If you're over 50, you can add as much as a $1,000 catch-up contribution. The year is still young, so there's plenty of time to use those higher contribution limits to maximize your tax-deferral opportunities in 2006. §

Performance Summary: Major Mutual Fund Categories*

Mutual Fund Category	Total Return with Dividends and Capital Gains Reinvested ---- Annualized through Feb. 17, 2006 ---- 1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	8.9 %	15.6 %	0.0 %	7.3 %
Mid-Cap Stocks (Core)	16.2	24.5	7.7	11.3
Small-Cap Stocks (Core) †	16.0	27.4	10.1	11.4
Global Stock (includes U. S.) †	14.4	21.1	5.1	8.1
International (non-U. S.) †	19.1	26.6	6.4	7.8
Balanced	7.3	12.4	3.1	7.1
General Bond	2.4	5.0	4.9	6.4
Int'l Income (non-U. S.) †	– 2.6	6.0	7.4	5.9
High-Yield Taxable Bond †	3.2	11.9	6.1	5.3
General Municipal Debt	2.6	4.1	4.7	4.8

* Source: Lipper Analytical Services, Inc., as reported in the *Wall Street Journal*, Feb. 18, 2006. **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. are affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

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Do Foreign Markets Still Offer Real Diversification?

Global diversification has been an abiding theme of the *Client Quarterly* since its earliest issues 17 years ago. Recent results across the world's equity markets have reinforced that theme. According to Lipper Analytical Services, "International" (non-U.S.) stock funds handily outperformed the average U.S. stock fund for the past one- and three-year periods, with especially strong results for funds investing in Latin America and other emerging markets. Yet there is evidence that *correlation* – the relative similarity of behavior – between U.S. and foreign markets is increasing, raising the question of whether global diversification still helps temper risk while enhancing potential return.

According to Tom Idzorek, research director of Ibbotson Associates in Chicago, "Changing time frames can change the story." And as with many investment issues, a short-term snapshot can be misleading. Ibbotson recently tackled the question on a more comprehensive basis, studying three decades of rolling five-year and ten-year returns for the Standard & Poor's 500 Index and the Morgan Stanley Europe, Australia, Far East (EAFE) Index.

Ibbotson found that these broad measures of U.S. and foreign stocks trended toward lower correlations (less similarity) from the mid 1970s into the mid 1990s. Since then the correlations have bounced higher, especially between large capitalization stocks in the U.S. and their counterparts that trade on the markets of other developed nations. But Ibbotson notes that their studies over longer time intervals have not indicated much real change in correlation. In other words, diversifying with foreign equities is a story that still has some legs.

Of course, low correlation is most valued by U.S. investors when stock markets are struggling here and foreign stocks pick up the slack. But some studies, including one by Dimensional Fund Advisors of Santa Monica, California, suggest that the performance of U.S. and foreign equities has, unfortunately, tended to converge rather than diverge on the downside. The accompanying table shows a few noteworthy occasions when global stock markets pretty much tanked together, inlcuding the bear markets of 1973-74 and 2001-02, plus the stock market crash in October, 1987.

This implies caution for those whose key portfolio management issue is risk control. It may also reflect a bit of universal investor psychology. Global bull markets tend to develop in stages, as investors emboldened by gains in one part of the world eye the potential for upside elsewhere. When one or more major markets starts to slip, investors can be quick to reduce *overall* stock market exposure and seek refuge in quality bonds and cash.

Several prominent financial institutions have recently encouraged investors to raise their overseas equity exposure. At the same time, the *Wall Street Journal* reported recently that sustained strength in *our* economy has sparked renewed interest from foreign investors in U.S. stocks. What's that old saying about the grass always looking a little greener on your neighbor's side of the fence? §

Not Much Help When Markets Are Really Tough

	S&P 500 Index[1]	MSCI EAFE[2]	70%/30% Blend	*Source:* Ibbotson Assoc.
1/73 - 9/74	– 43.%	– 35 %	– 40 %	
9/87 - 11/87	– 30 %	– 14 %	– 25 %	

	S&P 500 Index[1]	MSCI EAFE[2]	S&P/IFCI Emerg. Mrkt[3]	60%/30%/10% Blend
9/00 - 9/02	– 45 %	– 42 %	– 30 %	– 43 %

[1] Standard & Poor's 500 Index (large-capitalization U.S. companies)
[2] MSCI EAFE Index (developed markets in Europe, Australia, Far East)
[3] S&P IFCI Index (currently 23 investable emerging equity markets)

Note: Indexes are not available for direct investment; historical returns are *not* indicative of future results. See additional disclosures in "Performance Summary: Major Mutual Fund Categories" on page 2.

You Don't *Have* to Wait for Year-end to Take Your "RMD"

It's a bigger deal every year as more folks reach the age (70-1/2) at which they have to start taking taxable distributions from their individual retirement accounts. And there are those who have *inherited* IRAs subject to required minimum distributions (RMD).

Getting the RMD taken care of shortly before year-end has become an annual ritual, and an important one at that. Custodians generaly can't cut you any slack if you're late, and the tax *penalty* for failing to take the RMD is 50% of the amount that should have been taken. But there's no compelling reason to wait until late in the year to take that distribution. The amount of the RMD is based on the aggregate value of one's IRAs at the previous year-end. If there's any doubt on that score, your IRA custodian issues Form 5498 in the spring confirming that prior year-end value.

That may be a good time to go ahead and get the RMD taken care of. Your IRA custodian(s) will calculate the RMD if directed to do so. On the other hand, if you want to keep the money in your IRA a little longer, better pop a reminder on your calendar – you might highlight Thansgiving weekend – to get that RMD taken care of with time to spare. §

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Would a Prize by any other name have the same luster?

The late comedian Rodney Dangerfield built his entire act on a single complaint: "I don't get no respect!" Maybe he should have been an economist; some people think they get *too much*.

Consider the Nobel Prize in Economics, which isn't *exactly* a "Nobel Prize" at all. More than a century ago Alfred Nobel stipulated that his namesake honors be awarded to those who "shall have conferred the greatest benefit on mankind." He identified the fields of physics, chemistry, physiology/medicine, literature, and peace. Then in 1968 the Bank of Sweden, observing its 300th anniversary, established a "Prize in Economic Sciences in Memory of Alfred Nobel."

The Economics Prize carries the Nobel luster, but some have questioned whether economics exhibits the requisite scientific rigor or material benefits to mankind. Even Nobel's great grand nephew, Peter, took a swipe recently, characterizing the award as a "public relations coup by economists to improve their reputation."

On the side of the denizens of the "dismal science" you have the seminal work of Nobel economists such as Milton Friedman on monetary policy, Robert Merton and Myron Scholes on financial derivatives pricing, and Harry Markowitz, Merton Miller and William Sharpe on modern portfolio theory.

Perhaps the *real* value of the Economics Prize is to give all of us *non*-scientists something to argue about; aren't we all armchair economists? A decade ago the Royal Swedish Academy of Science broadened the Prize to recognize work in political science, sociology, and history, which should really provide for some heated debate over future recipients. All that said, there is still no talk of a Nobel Prize for astrologers – or maybe you just lump them in with the economists. §

Pension Trustees Are Prone to Chase Performance ... (from page 2)

edge if we can keep our wits about us. At least we don't have to worry about investment committees looking over our shoulders, second-guessing every decision and magnifying our natural predilection for rear-view-mirror investing. We can exercise patience and allow established managers with contrasting styles to bring their relative strengths to bear on our portfolios over time. Monitoring and evaluating manager performance is certainly prudent. Chasing it usually is not. §

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- or -

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