

Published by KMS Financial Services, Inc. * December 2007
 2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • <http://www.KMSfinancial.com>
 * Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

It's the Economy... the *Global* Economy

The unusually broad and sustained global growth that we surveyed in this publication 18 months ago is now closing out its fourth year. But challenges are piling up. Most prominent is the credit market shake-up triggered by the subprime mortgage mess. A deceleration in U.S. growth seems a foregone conclusion, and the debate has moved to how the *rest* of the world might weather that eventuality.

For decades the U.S. has been the lead engine of global growth. Since 1982 the U.S. has seen just 16 months of recession, compared to 64 months of recession across the prior quarter century, 1958-82. Our economic rhythms have echoed distinctly across other regions, especially those most dependent on exporting to our shores.

But patterns have been changing. When the U.S. had a mild recession in the early 1990s, global growth slowed but stayed positive. In the current cycle since 2003, industrial production has expanded more briskly outside the U.S. The distribution of global economic activity has shifted over time. According to the *Bank Credit Analyst*, since 1980 emerging Asia has surged from just 10% to about 26% of the world's output on a purchasing-power-parity basis. The U.S. share actually has held up fairly well, dropping about a percentage point from about 21.5% to 20.5%. Japan and the Euro region have seen their combined share fall from over 28% to 21%.

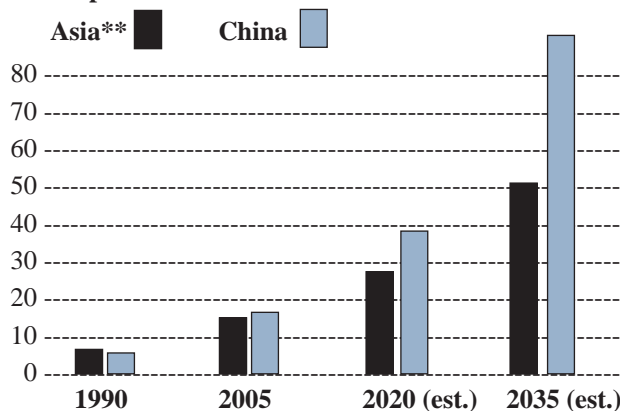
In its recent *Global Economic Outlook*, investment bank BNP Paribas presents a rather downbeat 2008 forecast for the developed economies of the U.S., Japan, and Europe. Canada also may slow somewhat, as it still looks to the U.S. to buy 76% of its exports. However, Canada's resources-rich mix of exports is what emerging Asian economies need, and BNP Paribas expects *those* economies to fare pretty well.

In particular, China is expected to log another year of growth in the 10% range, with India not far behind at better than 8%. These countries appear to have entered the kind of broad, transformational build-out experienced by the U.S. in the two decades following World War II. In both China and India, imports are now growing faster than exports, while the opposite trend has set in for the U.S.

This leaves investors with a pair of pivotal questions: 1) Can this divergence between developed and emerging economies persist? 2) Have global stock markets *already* fully discounted such a scenario? A lot of number crunching and portfolio strategizing will continue to focus on the myriad implications. Perhaps the U.S. engine, which has pulled the global economy through some dark passages and big changes in the landscape, has finally brought others to a point where they can provide more of the capital thrust. But transformative environments can be very volatile, so diversification is still the watchword. §

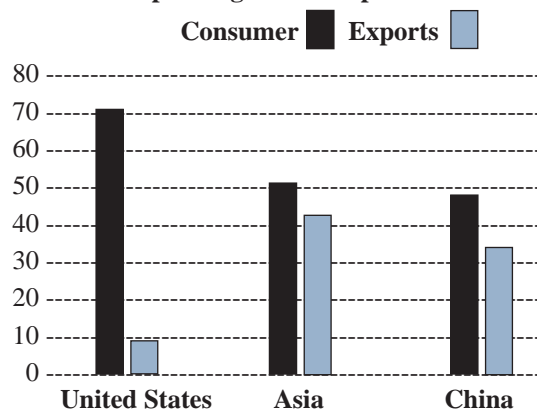
Asian Living Standards on the Rise....

Per Capita Income as a % of U. S. Levels*



But Consumption Still Plays a Smaller Role

Consumer Spending versus Exports as % of GDP



* Measured on a purchasing-power-parity basis, which adjusts for different currencies' buying power for a basket of goods and services.

** "Asia" defined as China, Indonesia, Malaysia, the Philippines, Thailand, Vietnam, plus some smaller countries in the region.

Source: World Bank, *World Development Indicators*, 2006

Volatile Markets, Hot Sectors Test Investor Discipline

Sticking with a careful, well-planned investment strategy is never easy. Volatile markets and dramatic returns for selected sectors make it especially tough. Over the past five years stock markets across the globe have produced gratifying results, but certain narrow sectors have really shot the lights out.

Investors have a long history of crowding into such parties just as the punch bowl is nearly dry. And the financial services industry hasn't always shown much temperance either. In just the final two years of the dot.com mania, the number of technology funds and their assets more than tripled, while many value-oriented managers with solid long-term records saw a net *outflow* of funds. The tech sector proceeded to get hammered in the 2000-2003 bear market.

More recently, 44 new mutual funds and ETFs specializing in natural resources and precious metals have come to market. Assets in such funds have more than quadrupled. Exposure to these sectors certainly can help diversify a portfolio, but an overload can add considerable risk. Just as the Standard & Poor's 500 Index became increasingly weighted toward tech stocks in the late 1990s, that same Index owes a fair bit of its advance since 2003 to the energy sector.

Another sizzler has been Chinese stocks. Shares on China's domestic exchange, so-called "A-shares" largely restricted to Chinese investors, surged 500% in just the past two years. Through November 30th, six of this year's 10 top-performing stock mutual funds are focused on the China region. Could a correction be in the cards?

Chasing hot *managers* can be similarly deleteri-

Large Pension Funds Seen Paring U. S. Stock Exposure

International diversification has been a persistent theme of this publication since its earliest issues in 1989. Yet one can't help but wonder about the reported push to overseas markets by some of the nation's largest investment pools.

The *Wall Street Journal* reported recently that several of the nation's largest public pension funds are implementing major reallocations from U.S. stocks to foreign equities. The parade includes New York State's Teachers' Retirement System and Common Retirement Fund, as well as Texas' Teacher Retirement, and Florida's Retirement System. Together these plans control a half-trillion dollars in assets. And the country's largest public fund, the California Public Employees' Retirement System, also is considering a major shift.

Consultants suggest that over the next few years the trend among many major institutional investors will be toward lower U.S. stock market exposure, typically from half or more of total assets to a third or less.

(continued on page 3)

ous. At the end of 2005, the Russell Company of Tacoma, Washington, looked at a universe of institutional equity managers who all had at least an eight-year track record. Of those whose performance ranked in the top quartile for the four years 1998-2001, just 40% were able to repeat in the top quartile for 2002-2005. And 25% of the '98-'01 stars fell to the *bottom* quartile for '02-'05. Likewise, the top performers for '02-'05 had had very mixed results over the '98-'01 stretch.

Even sophisticated pension trustees have shown a tendency to chase performance. As discussed in the Spring 2006 *Quarterly*, several academic studies suggest that trustees' decisions to switch managers, often based on short-term criteria, have been a net negative for their plans' long-term returns. (See the accompanying article on some large pension funds' *current* predilections.)

Market sectors, investment strategies, and management styles pass in and out of fashion. Volatility magnifies the temptation to jump from horse to horse. If one wants to do *some* portfolio tweaking, it may be more productive to shift a few dollars *away* from one's biggest recent winners and *toward* those holdings that have *underperformed* for a while. §

Performance Summary: Major Mutual Fund Categories*

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested			
	---- Annualized through Dec. 7, 2007 ----			
	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	8.9%	10.0%	11.5%	5.2%
Mid-Cap Stocks (Core)	8.0	11.9	15.8	9.2
Small-Cap Stocks (Core) †	1.2	9.0	15.6	8.2
Foreign Stocks †	17.5	19.5	21.3	9.2
Emerging Market Stocks †	43.9	36.8	35.8	14.2
Flexible Portfolio	10.5	10.9	12.9	7.4
General Bond	2.3	4.1	5.4	6.2
Int'l Income (non-U. S.) †	6.3	2.8	7.1	5.9
High-Yield Taxable Bond †	1.9	4.9	9.5	3.9
General Municipal Debt	0.6	3.1	3.8	4.2

* Source: Lipper, as reported in the *Wall Street Journal*, December 8, 2007.

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.

Is “Guaranteed Income” an Investment Asset Class?

Traditionally, asset allocation referred to what you *have*. Now some experts say it should include what you have *coming*. As more of us contemplate a retirement arc spanning three decades or longer, sources for dependable, long-term income are bound to affect how we position the rest of our investments.

Social Security is one example of a “guaranteed income” asset, but our claim on that revenue stream and its relative level are subject to the slings and arrows of future political and economic exigencies. Traditional pensions promise lifetime income for some workers, but the trend to defined contribution plans (401-k, etc.) will leave more retirees and their advisors with the challenge of generating adequate, sustainable cash flow from their own pool of retirement savings. Market volatility, interest rate cycles, and life changing events can conspire to make this tricky.

The basic immediate annuity offers a simple proposition: Turn over a chunk of capital to an insurance company in exchange for a stated income stream, perhaps for life or some “period certain.” But persistently low interest rates have made that equation relatively unattractive. And the upward creep in the cost of living make us all circumspect about permanently ceding control of large blocks of capital.

As noted in past *Quarterly* issues, variable annuity providers have generally led the way in offering long-term income guarantees that allow clients to retain exposure to potential capital growth. Now some retirement plans are adding options for participants to purchase units of future income at a discounted present value. Mutual fund companies and managed account providers also are rolling out offerings that marry these popular, flexible investment vehicles to underlying assurances of sustained, managed income.

In short, the rush is on to reshape financial products and services around this mounting challenge. As always, careful analysis of the costs, benefits, and trade-offs will be challenging as well. §

Large Pension Funds... (continued from page 2)

Foreign markets will attract a lot of those assets, along with global real estate, hedge funds, and private equity deals. Assuming sustained follow-through, this could certainly create some headwind for U.S. stocks.

Then again, there’s a little herd mentality and performance chasing at work here. Like so many investors, big pension funds fell in love with U.S. stocks in the late 1990s and took their proper lumps in the bear market. Now, with foreign markets and currencies having outperformed for five years, they’re headed overseas. One hopes they’re only a *little* late to *that* party. §

This Coming Tax Season May Seem a Little Squeezed

If you’re one of those folks who like to pull all their tax information together by the end of January, file a return by mid-February, and get a refund in March, you might want to take a deep breath. Things are likely to run a little differently this coming tax season.

AMT Debate Will Slow Things Down

For starters, at this writing Congress has yet to pass a “fix” to keep an estimated 19 million “middle income” Americans from falling prey to the Alternative Minimum Tax for 2007. Senators and Representatives across the political spectrum claim they want to shield those taxpayers. But such legislative imperatives attract efforts to attach all kinds of provisions for which the support is not nearly so bipartisan.

However this particular game of political chicken plays out, U.S. Treasury officials warned weeks ago that the uncertainty has already pre-ordained delays in processing 2007 returns and sending out refunds. Publication of some forms and instructions were delayed. And if compromise legislation passes, Treasury will be scrambling to translate it into effective corrections and guidance for tax preparers.

Come what may, many American households are headed for their close encounter of the first kind with the fiendishly complex Alternative Minimum Tax.

Brokerage Firms Holding Off on Tax Information Statements

In recent years brokerage firms have seen a marked increase in the use of securities that do not report final tax information to the holding firm until after January 31st. That has forced the issuance of many more *corrected* Tax Information Statements. Many firms, including KMS’ primary services provider, Pershing LLC, will wait to distribute these statements until February 15th. This should significantly enhance the accuracy and completeness of accountholders’ *initial* Tax Information Statements and cut the issuance of corrected statements at least in half.

The new mailing date applies only to taxable accounts receiving a regular Tax Information Statement (“1099”). The 1099-R and 1099-Q statements covering distributions from IRAs and other retirement plan accounts will still go out by January 31st.

Fighting Back with Technology

If you don’t like waiting for “snail mail,” monthly brokerage statements, trade confirmations, and tax statements can be accessed online at Pershing’s *NetExchange Client*® site (www.netxclient.com). Users can download their KMS/Pershing brokerage account transaction data into TurboTax® software. Check with your Representative to establish your online access. §

Last-minute HSA Contribution Can Snare Full Deduction

If you were planning to contribute to a Health Savings Account (HSA) but thought it might be too late to maximize the tax deduction for 2007, well, it's not. Prior to 2007, one had to prorate an HSA contribution based on the number of months one was eligible to participate during the year. But starting in 2007, as long as you're eligible during the last month of the tax year, you can take advantage of the applicable maximum annual contribution (up to \$5,650 for a family) plus any

catch-up contribution for those age 55 or older (up to \$800 this year).

As with most tax breaks there are specific conditions. For instance, if you become *ineligible* for some reason other than death or disability during a 12-month testing period (generally through November of 2008), contribution amounts for the months you *would have been* ineligible in 2007 will count as 2008 income. A penalty of 10% of that amount also will apply.

Long story short, there's still time to make a 2007 HSA contribution and get a meaningful tax break. Just check those rules. §

Another Global Phenomenon: Retirement Worries

America's Baby Boomers aren't the only folks fretting about their impending retirement. A lot of Germans, Brits, Koreans, and Japanese are pretty nervous too. This past summer, The Hartford Life Insurance Company surveyed more than 6,500 residents of those five countries, all over the age of 45, about their outlook and concerns for their golden years.

Japanese respondents came off as being the *most* worried; 87% cited concerns on some level about whether they'll have enough money to carry through retirement. Americans weren't very far behind with 80% noting significant concerns. The Britons, Germans, and South Koreans were a little more sanguine. Still, about two-thirds of each of those groups cited some uneasiness.

Many of those surveyed were concerned about both the adequacy of their own savings and the sustainability of their countries' public pension schemes (e.g., Social Security). Sounds like a lot of folks will be trying to do some serious catch-up savings. §

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
- Individual Stocks and Bonds
- Private Portfolio Management
- Online Access to Your Accounts
- Fixed & Variable Life Insurance & Annuities
- IRAs and Tax-qualified Retirement Plans
- "529" College Savings Plans
- Insured Certificates of Deposit