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CA Financial Services
828 8th Avenue
Lewiston, ID 83501
(208) 746-3270 phone
www.cafinancialservices.com

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2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • http://www.KMSfinancial.com
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Moving Inexorably Toward the "Cliff"

Presidential election campaigns have a propensity for exaggerating small differences. This plays into discussions of the impending "fiscal cliff," the combination of federal spending cuts and tax rate increases set to go into effect at the start of 2013 barring action by Congress and the president.

A series of tax rate reductions enacted more than a decade ago to combat the post-tech-bubble recession are set to expire at the end of 2012 with the following of most immediate interest to investors:

• The top tax rate on ordinary income rises from 35% to 39.6%;
• The top tax rate on qualifying dividends jumps from 15% to that top 39.6% rate;
• The top rate on capital gains moves from 15% to 20%;
• Dividends, gains, and ordinary income of upper earners becomes subject to added Medicare taxes;
• The temporary two-percentage-point cut in payroll taxes, in place since early 2011, ends.

The accompanying table projects the dollar impact – tax increase or spending cut – represented by key features of the cliff. Some involve more guesswork than others, and there's still a question whether *any* will occur without modification. So let's take them one at a time:

Expiration of the "Bush tax cuts:" Neither party actually favors such a broad rate increase. Democrats want to confine higher rates to high earners, while Republicans oppose any increase, so the dollar impact of any compromise may be much less. And it's notoriously difficult to project revenue gains (if any) from higher marginal rates. Targeted taxpayers tend to modify their financial dealings and portfolio choices in the face of such changes.

Expiration of the AMT fix: It's a rare Congressman who relishes the prospect of many more constituents dealing with this arcane corner of the code and the attendant extra taxes. A fresh fix seems fairly likely.

The end of the payroll tax cut: This appears to have quiet, bipartisan support, so it may well occur. Extended unemployment benefits are not really a major budget factor.

Reduction in Medicare payments to physicians: These dollars will still probably be captured by the medical complex one way or another.

Spending sequester: Fully half of this is to come from defense spending, so it figures to be a political hot potato and may represent some focused impact on defense contractors.

New taxes under Obamacare: This may be the factor most clearly dependent on the outcome of the election.

Expiring tax initiatives: Every tax break is some lobbyist's meal ticket. But a lame duck Congress might prove to be a graveyard for provisions that are at all vulnerable.

These issues are fodder for the campaign and probably some post-election political brinkmanship. But a hyperventilating press is a poor guide to major changes in long-term investment strategy. For example, history suggests it is quite difficult to predict the effect of tax changes on the performance of dividend-paying stocks. Individuals, businesses, and governments anticipate and adjust. The fiscal contraction outlined above would be spread over time and clouded by countervailing factors. In fact, it looks more like an extended off ramp than a cliff. ■

The Cliffhanger: Could All This Really Come to Pass?

Federal Tax or Spending Event	*Est. Impact 2013-14*
Expiration of tax-rate reductions from 2001-03	$340 billion
Expiration of latest Alternative Minimum Tax fix	$225 billion
Expiration of payroll tax cut and extended unemployment benefits	$150 billion
Reduction in Medicare physician payments	$ 30 billion
Spending sequester under the Budget Control Act due to the Super Committee's failure	$160 billion
New taxes under the Affordable Care Act	$ 48 billion
Expiration of various tax initiatives	$ 60 billion
TOTAL	**c. $ 1 Trillion**

Source: The Committee for a Responsible Federal Budget

Noting Signs of a Housing Recovery

Four years ago, with many housing markets in free fall, we wondered if contrarians might be seeing a strategic entry point for real estate investments. One key question was whether commercial property would follow housing into the abyss. That didn't happen, and now, three-and-a-half years into a stuttering recovery, it looks like housing may be coming around as well.

The sheer severity of the housing bust did prompt markets to assign high risk premiums to investment vehicles in that sector. That includes passive, indirect investments such as mortgage-backed securities, real

continued on page 2 ►

Reflecting on a Tough Five Years

This fall marks the fifth anniversary of the high water mark for most stock markets prior to the steep decline of 2008 into early 2009. The accompanying table's three-year and five-year columns reveal the kind of recovery that was required to bring broadly diversified equity portfolios back into barely positive territory for the half-decade.

If it's any comfort, much of the so-called "smart money" has struggled as well. According to Hedge Fund Research, Inc., the HFRX Global Hedge Fund Index posted return of –2.6% *annualized* for the five years ended August 31st. The hedge fund sophisticates' biggest misses appear to have been in the recovery phase. The HFRX was barely positive for the trailing three years, a sharp contrast to the averages posted for many mainstream mutual fund categories.

In the esoteric, multi-strategy milieu of hedge fund managers, averages may not count for much. As they say, there are lots of ways to skin a cat, and sometimes the cat just manages to escape the "skinning" entirely. ■

IRS Raises 401(k) Contribution Limits

Peering out toward year-end, we note that for 2012 the limit has been raised to $17,000 on elective deferral contributions for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan. The added "catch-up" contribution limit for the 50-or-older crowd remains at $5,500 (i.e., $22,500 total).

So if you have some extra cash on which you'd love to pick up a little extra yield, and you aren't already deferring the maximum into your retirement plan, it's pretty hard to beat the immediate return represented by that marginal tax deduction. We're just saying… ■

► *continued from page 1*

Housing Recovery...

estate investment trusts specializing in apartments, companies engaged in homebuilding and property development, and commodities such as lumber and copper.

Of course there isn't just one housing market but rather myriad local and regional markets with very different experiences in recent years. Even in some of the hardest hit markets, prices are stabilizing or edging higher. Institutional investors and risk equity players are seeking out distressed property opportunities, and individuals actually have been able to profit as well.

According to a recent white paper from PIMCO Investments, key market metrics are looking more favorable. Over the past two years, the shadow supply of seriously delinquent or foreclosed loans has dropped significantly, and many homes that carry a mortgage balance greater than the property's value are eligible for modification or refinancing.

One response to the notoriously loose mortgage lending of the housing boom has been a period of unusually stringent underwriting standards. Even a modest easing – call it normalization – coupled with such low interest rates could further energize home buying and support prices.

On the supply side, housing starts have been at depressed levels since 2008. Americans may have overdone it on the housing front in the decade leading to the bust, and household formations have run below trend the last few years. But renewed growth in households could run up against a tightened supply picture.

Extended trauma for the housing market may well have tempered Americans' passion for home ownership. That in itself has tended to bolster the economics of owning and operating apartments. And that has attracted more institutional investors to the business of owning and leasing single family homes.

For individuals, mutual funds specializing in real estate securities did turn out to be a rewarding sector the past few years. Apartments have been part of that story along with those low interest rates and investors' deep thirst for yield. Timing entry points is tricky, but diversification in professionally managed property has again proven to be a constructive portfolio component. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru Sept. 7, 2012 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	19.7 %	12.1 %	1.0 %	6.2 %
Mid-cap Stocks (Core)	16.5	14.3	2.1	8.5
Small-cap Stocks (Core) †	18.1	14.4	2.6	9.0
Foreign Stocks (Multi-cap) †	5.2	4.0	– 4.1	6.6
Emerging Market Stocks †	– 3.1	6.0	– 1.3	14.5
Natural Resources	3.9	9.8	– 0.9	12.1
Real Estate related	22.1	25.3	3.7	10.6
Flexible Portfolio	7.2	9.3	2.7	7.0
General Bond	7.8	8.2	5.9	6.4
Int'l Fixed Income †	1.9	5.9	6.7	6.7
High-Yield Taxable Bond †	13.2	12.8	7.0	8.7
General Municipal Debt	10.2	7.2	5.0	4.3

* Source: Lipper, as reported in the online *Wall Street Journal*, Sept. 8, 2012.
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 Little Return Without Much Risk

These days one welcomes any idea for picking up a little extra return without a lot of risk. One possibility is to step back from your investment portfolio and check the deductibles on your home and auto insurance. Taking a bit more risk in the form of higher deductibles can yield up real dollars over time.

According to ACE Private Risk Services, boosting the deductible from $500 to $2,500 on coverage for a $1 million home can cut the annual premium by about $900. Assuming a homeowner can bear the extra $2,000 in case of a mishap, and figuring that such mishaps are relatively few and far between, that tradeoff looks pretty positive.

ACE reports that the typical home it insures averages a claim only about every 20 years. And families often don't file a claim for covered damages that only exceed the deductible by a modest amount. They fear subsequent premiums will rise, so they *self-impose* a higher deductible on the theory it will save them future premium dollars. It may make more sense to make that higher deductible "official" and realize the savings up front.

With auto insurance, savings from higher deductibles can vary a lot depending on the value of the car and which aspect of coverage one evaluates (collision, comprehensive, liability). On a newer, higher-priced vehicle it's probably worth running the numbers. On an older clunker, collision coverage may not make much sense in any event.

Moving to higher deductibles may not require any action on your part. The trend for auto and homeowner's insurance has been toward higher deductibles as standard issue. Some major insurers have transitioned to setting the deductible as a percentage of the home's insured value, anywhere from 1-5%, subject to a specific dollar minimum.

This may complicate considerations a bit, but the basic exercise is the same. How large a deductible is still an acceptable risk, and how much can you pocket in premium savings by accepting that risk. Your agent should be able to help you play "what if" on the various components of your coverage to see where the trade-off looks most favorable. ■

Quiet Summer Suffering at the Pump

With gasoline prices hitting new highs just as both political parties were holding their national conventions, it was surprising that neither side chose to really flog that basic pocketbook issue. Obviously, four-dollar-plus gas just doesn't carry the shock value it once did. Or maybe it has been upstaged by a new school year's college tuition hikes.

Breaking Out the Cost of a Gallon of Gas

Month /Year	Retail PPG	Refining	Distribution / Marketing	Taxes	Crude Oil
May/00	$1.485	20.2 %	9.2%	27.9%	42.7%
May/01	1.702	26.4	14.0	24.7	35.0
May/02	1.392	11.9	14.2	30.2	43.7
May/04	1.983	30.6	7.8	21.2	40.4
May/05	2.161	17.9	12.8	20.4	49.0
May/06	2.907	21.9	8.8	15.8	53.4
May/07	3.146	27.9	13.3	12.7	46.1
May-08	3.766	10.0	4.7	10.6	74.7
May/09	2.266	17.6	- 3.9	19.5	66.8
May/10	2.836	8.4	13.3	14.2	63.9
May/11	3.906	14.1	10.2	10.3	65.2
May/12	3.732	13.0	10.3	11.1	65.4

Source: U.S. Energy Information Administration

Per the accompanying table, gas prices have run the gamut these past 12 years. And there's been an ebb and flow to the underlying components of those prices at the pump. Crude oil has rallied recently while other costs are accounting for a relatively small slice of the cost of filling the tank. Maybe that's the good news. More oil is turning up in lots of places, not least in North America. Any meaningful drop in the price of crude should bring real relief at the pump. ■

Timely Strategy for Charitable Givers

Between now and November 6th, most discussions of the income tax code will generate more heat than light. But once the election has rendered its verdict we could start to see serious tax reform proposals come to the fore. One common thread running through much of this backstage chatter is the idea of reducing marginal tax rates while curtailing or even eliminating some widely used tax deductions.

Back in June the *Wall Street Journal* outlined a series of proposals that various players have made to rein in the tax benefits of donating to charity, especially for upper income taxpayers. Whether any such change actually materializes, and whether it would be effective for 2013, is anyone's guess. But the *Journal* noted one possible strategy: establishing a donor advised fund to capture a high-value tax deduction in 2012.

Even if tax reform never arrives, contributing to your donor advised fund nets that bird-in-the-hand tax deduction while preserving flexibility to direct grants to your eventual recipient charities over whatever timeline and in whatever amounts suit you.

In fact, perhaps the most fundamental use of donor advised funds is to maximize the tax benefit of charitable gifts during one's peak earning years, building a fund through which charitable interests can be sustained and expressed for many years thereafter. Prospects for tax reform may just make that strategy a touch more timely in 2012.

Whether you are embarking on a more ambitious giving program

continued on page 4 ▶

Things Are Tough All Over; Even Nobel Prizes Take a Hit

If you feel like the financial furies of recent years have been picking on you in particular, rest assured, you're not alone. In the wake of weak results for the investments that underpin the Nobel Prizes, the Nobel Foundation has announced reductions in the value of those prizes. It's the first cut in 63 years, and the Foundation is also looking to trim the cost of its administration and the annual banquet where the awards are presented.

This year's winners will receive about $1.1 million each, 20% less than last year. The amounts awarded in six categories had risen gradually since the last reduction in 1949. But the Nobel Foundation traditionally has maintained a relatively equity-oriented portfolio. Overhead and prize money – a total budget running about $17 million annually – have been outstripping returns in that portfolio. Millions of individual investors certainly can empathize.

Alfred Nobel, the Swedish chemist and engineer who invented dynamite, established the prizes in 1895 to be awarded to individuals making exceptional contributions for the "benefit of mankind." He set aside a large portion of his estate to support the awards.

The Foundation hopes to get back on track to awarding higher prize amounts in the future. And it is said to be tweaking its portfolio to an allocation of 50% traditional equity, 20% fixed-income securities, and 30% alternatives such as real estate. It's a matter of keeping their eyes on the process as well as the prize. ■

► *continued from page 3*

...Charitable Giving

or simply considering efficient, tax-smart approaches to perpetuating your charitable interests in retirement, a donor advised fund can be a supportive platform for managing that part of your financial life. Your Representative has the facility to establish a donor-advised account right on the KMS's primary brokerage platform and facilitate the seamless transfer/donation of cash or appreciated securities.

A donor advised fund offers many attributes of a private family foundation, but without the attendant administrative burdens. Costs and minimum initial contributions are quite modest.

By the way, donor advised fund providers often maintain a helpful database of charitable organizations. If you're looking to do a little research on your own, the IRS recently launched an online tool entitled "Exempt Organizations Select Check." You can find it at *www.irs.gov/charities/article/0,,id=249767,00.html* and check out an organization's eligibility to receive tax-deductible contributions. It certainly doesn't hurt to make sure. ■

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CA Financial Services

828 8th Avenue

Lewiston, ID 83501

(208) 746-3270 phone