

Published by KMS Financial Services, Inc. \* June 2009  
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • <http://www.KMSfinancial.com>  
\* Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

## Back to Basics: The Prospects for Corporate Earnings

A financial panic can be all-consuming, especially in our constantly connected, media-soaked age. But as the panic subsides we confront familiar questions that preoccupy analysts and investors over the longer arc of economic and market cycles. Such as: Where are corporate earnings headed?

Companies still produce goods and services, and some even do so at a profit. Earnings for *nonfinancial* U.S. companies have held up surprisingly well considering the erosion across the broad economy. But the financial sector had become an outsized piece of the pie, and its reported results have been clobbered by write-downs for nonperforming loans and other “toxic” assets. Overall operating earnings for the Standard & Poor’s 500 are on track to have fallen a cumulative 40% over the three years ending with 2009.

The underlying quality of earnings has been harder to read. Nonfinancial companies have maintained relatively healthy productivity growth and respectable profit margins. This may stem partly from their speed in shedding workers, as evidenced by the surge in unemployment. Companies may also be continuing to benefit from technology put in place over the past 15 years and now being tapped to even greater advantage in a tough sales environment.

But that’s the past. Stock prices are supposed to discount the future, and the market’s recent bounce suggests a recovering earnings outlook. The prime factors that define companies’ profits include labor, materials, and capital costs relative to marketplace demand for their products and services. All are affected by one another as well as the broader economy.

### Turning 70½ This Year?

As discussed in our “Spring” issue, those who would normally be required to take a 2009 IRA distribution can elect to keep that money working in their retirement accounts this year rather than booking it as taxable income. That includes those who happen to be turning 70½ in 2009; they have until December 31, 2010, to take that first required minimum distribution.

If you have questions or just want to make sure you’re on top of your required IRA distributions, check with your KMS Representative. §

### Parameters of a Contraction

	2007	2008	2009*
S&P 500 Operating Profits **	-5.9	-33.0	-15.0
Total Profit Margins (%)	8.6	7.8	7.0
Real Capital Spending **	4.9	1.8	-12.0
Financing Needs (in \$ billions)	186	245	230
Corporate Inflation Rate (%)	1.7	- 0.5	- 1.0

\* BCA Research forecast    \*\* % Change on the Year

A revival in demand should be an overall positive, but it might also necessitate some rehiring which could dampen productivity at least temporarily. As suggested above, the pace of new investment in equipment and software has fallen over the past two years which also may impair future productivity gains. Corporate profits had a run of above-trend growth from 1993 through 2006, but the recent decline has returned them to their longer term trend line.

With at least a modest but sustained economic recovery, profits should be able to grow at a healthy pace over the next few years. U.S. companies doing meaningful business overseas may benefit from a more robust rebound in other regions, albeit selectively. Emerging Asia looks to have better growth prospects, but it has accounted for only about 15% of U.S. companies’ offshore earnings. Europe has accounted for about half, and its recovery may well lag. One more caveat: the new Administration is clearly targeting overseas profits for a tax hike.

If earnings come through, there’s still the question of how the stock market will value them. With the sharp run-up since the lows of early March, the S&P 500 Index now rests at about 15 times trailing earnings, based on the national income product accounts. Historically that’s neither expensive nor a screaming bargain, but trailing earnings have been at recession levels. Prevailing interest rates also play a role. If the recovery boosts market yields on bonds and other fixed-income alternatives, that competition for investor dollars could keep a lid on stock prices.

One thing looks fairly certain. Financial stocks will have a lower profile in the averages, and their profit potential could be tempered by heightened regulation and less leverage. The panic of late 2008 may have subsided, but the economy still faces the headwinds of consumer caution, housing overhang, the prospect of higher taxes, and the drive to deleverage. §

## Edging Toward a Measure of Investing Confidence

You may not be shocked to hear that Americans aren't feeling too hot about their prospects for a cushy retirement. In the recently released Retirement Confidence Survey from the Employee Benefit Research Institute the number of workers who say they are "very confident about having enough money for a comfortable retirement" fell to the lowest level (13%) in the survey's 17-year history. That's understandable given the depth and breadth of declines for financial and real estate assets from late 2007 into early 2009. Watching nearly every mainstream investment asset and market sector get beat up in concert can make almost any strategy seem iffy.

Even so, investors appear to be taking the measure of market risk and opportunity. They scooped up stocks off the early March lows with a sense that the negativism may have gotten a little overdone. Quality corporate and municipal bonds found some footing. Low yields on U.S. Treasury securities suggest there's still plenty of risk aversion out there. But emerging markets have enjoyed an impressive rally, so *somebody* is stepping out onto the risk frontier.

The plunge in many Americans' level of confidence is no small part of the current economic challenge. But as shown in the table below, 2009 has taken on a pretty positive cast for a wide range of investment categories. Even the 10-year lookback isn't all that discouraging considering that it encompasses two significant bear markets and a period of persistently low interest rates and inflation. The road back will have its twists and turns. Careful diversification and ample liquidity will be key to rebuilding portfolios... and a measure of confidence. §

## Exchange Traded Funds Have Become an Investment Staple

Five years ago the *Quarterly* took an introductory look at Exchange Traded Funds (ETFs), at that time still a relatively novel tool for portfolio builders. There were just 130 issues on the market holding about \$175 billion in assets. Today there are about 700 ETFs listed on U.S. exchanges with assets exceeding \$500 billion. The global ETF industry boasts more than 1,600 issues.

As we noted five years ago, an ETF typically holds a basket of securities (stocks or bonds) designed to track a specific market sector or index. Shares of an ETF trade like a stock at intraday prices that track the aggregate market value of its underlying holdings. ETFs usually are not actively managed, so fees are very modest and the holdings relatively transparent. They are structured to avoid, or at least minimize, distribution of taxable gains to shareholders.

That combination of attributes has carved out a place for ETFs in the portfolios of many individual investors, asset allocation programs, and institutional portfolios. Even some actively managed mutual funds are finding ETFs to be a useful tool alongside their favorite individual stock and bond picks.

The ETF marketplace is fertile ground for new products. According to Barclays, a major issuer, there are plans afoot to launch over 700 new ETFs this year. However, not every launch stays aloft. The number of domestic ETFs actually declined slightly in the first quarter as 21 issues were delisted. And there are other considerations. An ETF often represents a fully-invested play on a specific industry, commodity, country, or market sector. That can mean greater volatility than a more broadly diversified mutual fund.

An ETF's share price may not *always* reflect an aggregate of the exact current prices for its underlying securities. During the trading day each ETF publishes its indicative intraday value (IIV) every 15 seconds. Efficiency in an ETF's pricing and trading tends to reflect the market liquidity of its holdings. In general, traders would rather *not* pay a premium over the IIV when they buy an ETF.

Finally, *some* ETFs are quite speculative due to their sector and/or use of leverage. If you find yourself intrigued by an ETF that has skyrocketed recently, remember that a rocket's fall back to earth can be just as spectacular. §

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

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested --- Annualized through June 12, 2009 ---				
	YTD	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	7.8%	-26.9%	-6.4%	-1.6%	-1.1%
Mid-Cap Stocks (Core)	12.3	-29.7	-6.7	-0.1	4.1
Small-Cap Stocks (Core) †	9.7	-26.2	-7.7	-0.4	5.1
Foreign Stocks †	12.8	-30.8	-4.5	3.4	3.4
Emerging Market Stocks †	39.3	-31.3	4.0	13.5	9.8
Flexible Portfolio	8.8	-15.1	-1.3	2.7	3.7
General Bond	2.0	-3.6	2.6	3.5	5.6
Int'l Income (non-U. S.) †	1.1	1.5	4.6	4.5	5.4
High-Yield Taxable Bond †	23.1	-9.2	-0.7	2.4	2.9
General Municipal Debt	8.3	-1.6	0.9	2.5	3.5

\* Source: Lipper, as reported in the *Wall Street Journal*, June 13, 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.

## Criticism of Target-Date Funds May Be a Little Unfair

Back in the fall of 2007 the *Quarterly* discussed one of the hotter trends in 401(k) investing: *target-date funds*. These are broadly diversified asset-allocation vehicles managed with an eye toward one's retirement time horizon. A "2020" target-date fund would comprise an allocation with that investor profile in mind and make adjustments as that date draws nearer.

Target-date funds got a big boost when the 2006 Pension Protection Act identified them as a "qualified diversified investment alternative." That gave retirement plan sponsors comfort that they could direct contributions to these vehicles as a "default" choice based on a plan participant's age.

This helped address several issues for 401(k) sponsors and advisors. Many participants had tended to simply leave their plan accounts in very conservative default investments, such as money market and stable value funds, with limited prospects for long-term growth. Participants who did try to reallocate their accounts were often confused by the range of investment choices and longer-term allocation decisions, or they simply chased the previous year's hot performers.

The timing turned out to be less than ideal. Even the most broadly diversified target-date funds took their lumps in the global market debacle of 2008 and early 2009. The hit was especially disturbing for those who had selected funds with target dates in the relatively near future – say 2010 or even 2015. At this writing, the average trailing one-year returns for those two "targets" are -15.6% and -19.0%, respectively. And that's after the strong rally since March.

Now the hunt is on for what went "wrong." Why weren't the funds positioned more conservatively? Why did funds with the same target date but different managers perform differently? But the upset over target-date funds is largely due to misplaced expectations. A recent survey by Envestnet Asset Management and Behavioral Research Associates points up several misconceptions among plan participants. Perhaps most striking was the finding that 62% of those surveyed thought that simply picking a target-date fund would *ensure* their ability to retire by that date.

As we noted 21 months ago, there's no super-secret formula for designing the perfect target-date fund, and the exact right mix for somebody retiring in 10, 15, or 20 years is not settled science. Most target-date funds were designed to be held as diversified core portfolios well *into* retirement, retaining meaningful equity exposure beyond that threshold date. After all, you don't need *all* of the money the day you retire.

Target-date funds were established simply to provide a convenient, diversified, long-term portfolio managed with an eye toward a certain retirement timeline. They were *not* set up to cure all the other ills that afflict 401(k) investors such as short-term, emotion-

## Several Factors Boost Relative Yields on Municipals

Municipal bonds have been a traditional pillar of conservative portfolios: a tax-favored harbor considered almost as safe as U.S. Treasury paper. But state and local governments have been anything but immune to the credit boom and bust of the past decade. Today all but a few of the 50 states and many cities face significant – even urgent – budget problems, prompting some uneasiness in the muni bond market.

State and local governments are a big part of the national economy, employing 20 million Americans and accounting for about 13% of gross domestic product. They derive revenue from a mix of corporate and personal income taxes, property-based levies, sales taxes, and user fees. The economic downturn is undermining all of those revenue streams to an extent not seen since the early 1980s. And other factors have exacerbated the upheaval in tax-exempt credit markets.

Like many consumers, municipal and state governments were attracted to the past decade's historically low interest rates. At the same time, appetite for their debt was expanding beyond its traditional base of tax-sensitive individual investors. Hedge funds, closed-end mutual funds, and brokerage firms all became significant players in the muni market, often on a leveraged basis. The growth of insurance for municipal debt improved market access for smaller, less credit-worthy issuers.

Borrowing by state and local governments doubled over the past 10 years after holding pretty stable from 1988-98. That debt must be serviced despite the hit to revenues. With credit markets tenuous and many of those non-traditional buyers having backed away, the options for bridging the gap with more debt are limited. In general, state and local government spending continued to grow in 2008, but cutbacks are a given as these entities try to get their finances in order.

One upshot of all these trials is a run of unusually high yields on munis relative to comparable-maturity Treasury securities. This is an apparent opportunity for tax-sensitive investors, but with thousands of different munis on the market, research and issuer quality are key. Established muni fund managers offer diversification and research capabilities to try to minimize the issuer and event risks that come with holding just a few bonds. Carefully selected, high-quality individual bonds also can serve investors well, especially with some laddering of maturities as a hedge against the possibility of higher interest rates. §

driven investing and the failure to direct anywhere near enough savings toward retirement in the first place. We can hope that any efforts to "fix" target-date retirement funds don't end up watering them down to the point of uselessness. §

## Going Paperless Just Got a Little Easier

Clients with KMS brokerage accounts held through Pershing LLC can access statements and trade confirmations online at NetExchange Client<sup>®</sup> ([www.netxclient.com](http://www.netxclient.com)). NetXClient is a comprehensive financial website with a complement of account-related features and investment information. But if you're *just* looking for online statements and confirms, now there's My eDocument Suite<sup>®</sup> ([www.mydocumentsuite.com](http://www.mydocumentsuite.com)), a self-service site focused on that specific service.

At My eDocument Suite you create your user ID and password, view and download your documents, and turn the paper on and off as desired. If you are already a NetXClient user, the same ID and password should work at My eDocument Suite. If you're a *new* user, just note that KMS' Financial Organization Number is "4DR." That information plus your account number should be all you need to get started.

Why not try going paperless at My eDocument Suite and/or NetXClient? Your confidential statements and confirms won't be floating around in the mail any more, and you might save a tree or two. Check with your KMS Representative for further information. §

## Oil Continues Its Merry Ride

Six months ago the price of a barrel of oil had dropped to the \$40 range after having topped out as high as \$148 just last summer. The "Winter" *Quarterly* noted that oil investments were "quite unloved at the moment, but moments pass." Crude did slip a little further, to the mid 30s by February, then staged another turn-around. The price per barrel recently climbed back above \$70 despite a sluggish global economy and apparently healthy inventory levels at U.S. refineries.

This publication claims no special ability to forecast prices for oil or any other commodity for that matter. We only note that with something so essential and sensitive to global economic activity, there appears to be a chronic tendency for the market price to overshoot on both the up- and down-swing of the cycle.

Nearly three years ago the *Quarterly* discussed this topic under the title, "Oil Prices Could go Either Way, and Surely Will." How's that for going out on a limb? As it happened, a barrel of crude was running about \$70 then too, which also happens to be the approximate midpoint of its range over the past decade. What does it all mean? It's hard to say. §

### 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