KMS
Client Quarterly
Summer 2010

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

Published June, 2010, by KMS Financial Services, Inc. *
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • http://www.KMSfinancial.com
* Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

As Markets Swing and Swoon, Portfolios Can Fall Off the Track

The past few years, not to mention the decade, have put investors through a wringer. No need to rehash all the highs and lows. In fact, there may be too much attention paid to the highs and lows at the expense of long-term objectives and strategy.

Stocks suffered mightily in 2008, so in 2009 investors poured unprecedented sums into *bond* funds. Then in response to the big comeback rally, *stock* fund purchases surged in late 2009 and early 2010. Investors also have chased gold and oil across their respective peaks and valleys.

For those with a longer time horizon, signals from the past decade may be deceiving. It's not just that the Standard & Poor's 500 Index had one of its worst decades ever. The outperformance by long-term Treasury bonds over stocks was also a record – an 8% *annualized* spread.

Such periods are rare. A study of 889 monthly rolling 10-year periods from 1935 through 2009 showed Treasury bonds beating the S&P 500 only 14% of the time. The average for *all* periods was a 5.3% annualized advantage to the stock side.

Historical reassurances are fine, but those 300-point down days for the Dow are jarring in real time. We might take a little more *current* comfort from stock dividends. Dividend payouts did fall in 2009, but they've been recovering lately. And analysts have noted the relative strength of corporate balance sheets through the recession. By the end of 2009 the S&P 500's dividend yield was approaching the 10-year Treasury bond yield, and 72 stocks in the S&P were sporting dividend yields above that benchmark.

Last year's rally was led by the lower dividend payers, which is common in the rebound from a steep market decline. But over the trailing *ten* years, stocks that paid higher dividends outperformed. Many non-U.S. companies pay higher dividends, advancing the argument for global diversification.

10-Year Average Annual Returns for Broad Asset Categories

30 Rolling 10-calendar-year Periods, 1970-2009

Asset Category	High Return	Low Return	Average Return
U. S. Stocks [1]	19.2%	– 1.4%	**12.4%**
Non-U.S. Stocks [2]	22.8	1.2	**11.6**
Commodities [3]	20.8	2.1	**9.5**
U. S. Bonds [4]	15.6	2.8	**9.4**
Cash [5]	9.0	2.7	**6.1**
Gold [6]	31.7	– 5.0	**5.3**
Inflation [7]	8.7	2.4	**4.4**

*** Sources:** [1] *S&P 500 Index;* [2] *MSCI EAFE Index;* [3] *S&P GSCI Index;* [4] *Ibbotson Long-Term Govt. Bond Index;* [5] *U.S. 3-month T-bills;* [6] *gold spot price from Bloomberg;* [7] *Consumer Price Index*

With interest rates at historic lows and most of the world's central banks still quite accommodative, gold has been hitting new highs. But as the accompanying table suggests, gold's longer record is as an inflation tracker, and the ride can be bumpy.

To everything there's a season; it's just hard to know which comes next. But it's *always* a good time to check and see if we've become overweighted to short-term concerns at the expense of broad diversification and long-term objectives. ■

Hanging with the Euro, for Now

Three months ago the *Quarterly's* lead story was the gathering storm in the eurozone, centered over the prospect of Greece defaulting on its sovereign debt. That storm has surely intensified. The euro has hit a four-year low against the dollar, and what seemed the remotest of possibilities then – abandonment of the euro by some member counties – is now widely discussed.

As noted three months ago, the current crisis is "the first major calling of a question at the heart of the European Monetary Union: How does a common currency handle very divergent fiscal stresses among member countries?" The apparent answer is, not terribly well. But undoing the euro would be no simple matter, even for just one of the EMU's members.

Greece may be tempted to reinstitute the drachma and reclaim control over its own monetary policy. But if its transparent objective would be the flexibility to devalue, such a move would simply constitute a different form of restructuring or partial default on debts now owed in euros (or dollars). Greek pensioners and public employees might retain their pay and benefits in *nominal* terms, but their buying power would almost certainly take a big hit. A country's standard of living and currency eventually reflect the relative productivity of its people and resources.

At the other end of the spectrum, a decision by Germany to pull out of the euro project and reinstitute the deutschemark could entail steep losses for German banks holding the sovereign debt of weaker eurozone countries. That relatively quantifiable cost may look better than an

continued on page 4 ►

"Flash Crash" Puzzles Officials

It was easy to miss the market's "Flash Crash" the afternoon of May 6, 2010. The Dow Jones Industrial Average was already having a bleak session – down more than 300 points – when, with about 90 minutes left in the trading day, a host of stocks went into free fall. In a matter of minutes the Dow dropped nearly another 700 points or so before rebounding just as quickly. Traders and investors were "relieved" to see the Dow close down *only* 342 points.

In its immediate aftermath various theories and rumors circulated as to the Crash's cause. But no single, concrete explanation has surfaced. There simply appears to have been a confluence of factors triggering a sudden reduction in liquidity and a lack of bids from market makers.

The stock exchanges' immediate response was to invoke their "Erroneous Trade" rule, modified somewhat for the situation. Any trade that executed after 2:40 pm at a price at least 60% away from the national best bid or offer was canceled. Over 300 different securities were affected, a sizable majority of which were exchange-traded funds (ETFs) and closed-end funds. For a few moments some issues were trading for pennies on the dollar.

U.S. exchanges have instituted a circuit-breaker pilot program for S&P 500 stocks. It would halt trading in a security if its price moves by 10% within a five-minute window. The Nasdaq market has introduced its "Volatility Guard" with mini-circuit breakers across *all* Nasdaq-listed issues. The Securities & Exchange Commission is reviewing existing market-wide circuit breakers that did not trigger on May 6th.

The Flash Crash did offer some useful reminders. For instance it highlighted the fact that ETFs are a relatively new factor in the market. The sudden drop in some underlying securities created a big pricing challenge for ETF shares. For a few uncomfortable minutes many market makers simply backed away.

The episode also offered a refresher on stop-loss orders. These are used by the holder of a security to protect against a decline below a certain level. But when a stop-loss is triggered it becomes a *market* order. If a stock is falling fast, that market order may execute well below the trigger price. To protect against that possibility one can use a stop-*limit* order. Then if the stop is triggered it becomes a *limit* order which only executes at the limit price or better.

Of course a stop-limit order may not get an execution at all. There's no one strategy that's perfect for all scenarios. The key is to understand how different types of orders actually work and implement the approach best suited to your purposes. ■

As Time Goes By

This has not been a stellar quarter for stocks. But one key gauge of long-term performance may not suffer much. We're talking about the widely watched 10-year results for stocks and investment managers. Nobody knows how markets will fare in the months ahead, but we *do* know that those 10-year numbers will be shedding some pretty tough quarters from the 2000-2002 era.

In calculating 10-year returns, a long-ago quarter counts just as much as the new one which at this writing would need a late rally to beat the –2.9% from the second quarter of 2000. That was one of four straight down quarters set to exit the 10-year calculation over this next year.

As shown in the accompanying table, such periods can be a profound challenge for investors. But well diversified portfolios lived to fight, and prosper, another day. ■

Quarters to Drop	*S&P 500 Price Index % Rise*	*/ % Fall*
2000–2		– 2.9%
2000–3		– 1.2
2000–4		– 8.1
2001–1		–12.1
2001–2	+ 5.5%	
2001–3		–15.0
2001–4	+10.3	
2002–1		– 0.1
2002–2		–13.7
2002–3		–15.6
2002–4	+ 7.9	
2003–1		– 3.6

Source: *www.BigCharts.com*

Investment Performance Review	**TOTAL RETURN *** **(dividends and capital gains reinvested)**			
Major Mutual Fund Categories *	**--- Annualized thru June 4, 2010 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	13.3%	– 9.5%	– 0.4%	– 1.1%
Mid-cap Stocks (Core)	22.4	– 8.5	1.6	2.7
Small-cap Stocks (Core) †	21.1	– 8.3	1.7	5.7
Foreign Stocks (multi-cap) †	5.4	–12.2	2.2	2.8
Emerging Market Stocks †	17.7	– 5.3	10.6	9.5
Flexible Portfolio	10.6	– 3.7	2.2	2.8
General Bond	12.3	4.1	3.6	6.5
Int'l Fixed Income †	4.6	5.6	3.9	6.2
High-Yield Taxable Bond †	23.8	2.4	4.9	5.4
General Municipal Debt	10.1	3.3	3.1	4.7

* Source: Lipper, as reported in the *Wall Street Journal*, June 5, 2010. **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.

Not Much Relief for Thirsty Savers

A persistent feature of the recent financial landscape has been the virtual absence of any yield on the lowest-risk savings instruments. Money market funds, bank savings accounts, and short-term Treasury bills have barely bettered the returns from stuffing cash in a mattress.

It goes without saying that we must be near the low for short-term rates. But what are the signs that they'll head higher any time soon? The Federal Reserve has shown no such inclination. At its recent meetings the Fed's Open Market Committee has restated its intention to keep benchmark interest rates "extremely low" for an "extended period." That's not a cheerful note if you're holding lots of cash or you need income from the conservative stratum of your portfolio.

Therein lies a widely shared dilemma. Does one take the plunge into longer maturities to reach for a little more yield, knowing that if rates do finally make a move those securities could take a market value hit? Or does one wait it out at effectively zero yield with cash ready to pounce on those higher rates that might be just around the corner?

Maybe the answer is a bit of both. Even if a tightening were to be signaled at the very next FOMC meeting, the Fed is expected to be pretty deliberate about its implementation. Despite flat rates, the dollar has made a big move up against the euro. Recent employment numbers have been lackluster and inflation indicators benign.

One can always shop certificates of deposit out on the yield curve, although laddering over a year or two right now still leaves a blended yield below 1%. But if rates stay flat, any extra yield may be welcome. And if they rise, those laddered maturities will roll over in fairly short order.

Mutual funds that focus on short-term, investment grade holdings have averaged small, positive total return so far this year, and annualized yields generally are above 1%. But small gains could turn to losses if interest rates perk up.

In the "new normal" of hyper-caution and modest portfolio expectations, picking up even a percentage point on low-risk reserves can feel like a win. But if it's *really* "long-term" money, it might make sense to keep looking for openings to deploy some of that dry powder into investments with a longer time horizon and at least the potential for meaningful gains. ■

Year at Harvard Officially Tops $50k

Harvard College recently announced the official tab for this coming year's tuition, room, board, and other fees: a cool $50,724. Fortunately there are still a few relative bargains such as Yale at *just* $49,800. A few schools charge even more than those two brain trusts, but what's a few grand at those levels?

Prestigious private schools actually claim to be holding the line on tuitions even as many public universities impose larger *percentage* increases due to stressed state budgets. About half of all students at the priciest schools receive some financial aid, and more are now reportedly seeking help.

The key year for financial aid purposes is actually the one starting January 1st of your student's *junior* year in high school. But even once a student is in college it's good to stay in touch with the financial office. Under "professional judgment reviews" adjustments can be made to aid packages in view of a parent's job loss or other financial reversals. Documenting a meaningful decline in home value also can help.

Under the recently enacted *healthcare* bill, the federal government is taking over the subsidized student loan business. This is supposed to deliver slightly lower rates and more forgiving provisions for some student borrowers, but early reports indicate there may be processing bottlenecks. Those who expect to need a student loan should get the wheels turning early. ■

A Little Tax Break to Help Cover Long-term Care

Congress passed the Pension Protection Act way back in 2006, but many provisions were set to trigger later. Starting this year, one of those provisions allows for tax-free payments from deferred or immediate annuities to pay for long-term care insurance.

A *deferred* annuity that has grown in value eventually incurs tax on that gain when the annuity holder takes distributions, typically on a last-in, first-out basis. But if distributions are used to pay long-term care premiums *directly*, one avoids the income tax that would otherwise be due. The actual tax savings depends on the embedded gain in the annuity. For example, if 25% of the contract value represents gain, then 25% of the amount used to pay LTC premiums will be counted as a reduction of gain left in the contract. The other 75% is counted as a reduction in the contract's remaining cost basis.

Payments from an *immediate* annuity are usually partially taxable. A tax-exclusion ratio, based on the terms of the annuity, age of the annuitant, and other factors, determines the portion of the payments to be taxed as ordinary income. But if the payments go directly to pay long-term care premiums, *no* portion is taxable.

This may be an opportunity for investors who are buying long-term care coverage and are also taking (or will need to take) distributions from an annuity. It is also fostering the development of more annuity and life insurance contracts that *incorporate* provisions for long-term care. Demographic factors ensure that will be a growing preoccupation in the years ahead. ■

Healthcare Bill Nips at HSAs

The healthcare bill enacted some months ago is an immense piece of legislation with myriad provisions that few people understand as yet. But there are some basic changes for Health Savings Accounts (HSAs), a tax-favored savings vehicle covered in these pages from time to time.

Just to review, an HSA is a companion to high-deductible health insurance coverage that meets certain other qualifiers. Contributions to an HSA are tax-deductible, up to applicable limits, and withdrawals that are used for qualifying medical expenses are not subject to income tax or penalty.

There are no rule changes for HSAs in 2010. But starting in 2011, over-the-counter medications (i.e., non-prescription) will no longer be considered *qualifying* medical expenses. Withdrawals taken from an HSA for *non*qualifying expenses are counted as taxable income and currently incur an additional 10% tax penalty. Starting in 2011 that penalty jumps to 20%.

Of course the real value of an HSA is *not* in snaring a tax break on aspirin and throat lozenges. It's in making strategic use of that tax incentive to purchase cost-effective, high-deductible health insurance *and* to build a reserve against true medical emergencies and the inevitability of longer term healthcare needs. Even those who *cannot* deduct an IRA contribution *can* deduct an HSA contribution.

There are other provisions of the healthcare bill that *may* tweak HSAs a few years down the road. We'll take a look at those when and if they actually come to pass. ■

► *continued from page 1:*

Hanging with the Euro, for Now

open-ended backstopping of the fiscal fantasies of profligate euro partners. On the other hand, Germany has been a clear winner in the integrated European market fostered by a common currency.

Any member turning away from the euro would face complications well beyond those basic dilemmas. Europe is a continent on which history and geography have conspired to place a disparate and sometimes fractious mélange of nations. The logic of facilitating trade and economic integration remains compelling despite the political challenges and manifest moral hazard.

The EMU has set a trillion-dollar lending facility for its most fiscally challenged members. The European Central Bank has broken new ground by buying certain members' debt to support it in the market. The austerity prescription has not gone down well in the streets of Athens, and observers are increasingly skeptical of that nation's ability to avoid an eventual debt restructuring. Greece may be just the first of several countries to face such a reckoning as global markets sharpen their focus on fiscal sustainability. ■

For information on any of the items listed below, please call:

CA Financial Services

208-746-3270 phone

208-743-9514 fax

www.cafinancialservices.com

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

- Mutual Funds, Unit Investment Trusts, & Exchange-traded Funds
- Individual Stocks and Bonds
- Private Portfolio Management
- Life Insurance & Annuities
- Online Access to Your Accounts
- IRAs and Tax-qualified Retirement Plans
- "529" College Savings Plans
- Insured Certificates of Deposit

CA Financial Services

828 8th Avenue

Lewiston, ID 83501

(208) 746-3270 phone