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Returns Look Good, Markets Seem Jumpy

The recent rough and tumble in the stock and bond markets has had the feel of an inflection point. But then, true inflection points are often clear only in hindsight. Time will tell whether the gains of the past few years are due for a steep correction or just a mild consolidation. Either way, any pick-up in volatility is noteworthy as the factor most likely to knock one off the track of a well-considered investment strategy.

Many who experienced the market plunge of 2008 struggle to erase that sickening sense of free fall. As recently as August, 2011, stocks had a four-day run over which the average *daily* change for the Standard & Poor's 500 Index was 5.1%. Then near the end of 2012, the drama of the "fiscal cliff" negotiations clipped about 3% off major stock averages, a loss recouped in just two days.

But three or four days can neither make nor break one's long-term investment success. And over time stock returns tend to reflect the ability of those underlying companies to grow their top *and* bottom lines. The kind of factors that drive the market's brief bursts and hiccups, such as parsing the latest utterance of the Federal Reserve chairman, are apt to be remembered merely as background noise if at all.

There are always good reasons to be cautious, but our perceptions of volatility may be a bit exaggerated. Investment consultant Wilshire Associates, studying the very broad Wilshire 5000 index, found that market swings of more than 30% were *not* much more common the past 10 years than in the prior 23. And monthly gains or declines greater

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Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru June 7, 2013 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	27.3 %	16.9 %	5.0 %	6.9 %
Mid-cap Stocks (Core)	29.4	17.2	5.7	8.9
Small-cap Stocks (Core) †	30.1	17.5	6.9	9.5
Foreign Stocks (Multi-cap) †	25.4	11.4	– 1.2	7.2
Emerging Market Stocks †	13.2	5.9	– 1.9	13.5
Natural Resources	24.8	13.9	– 3.8	11.6
Real Estate Related	15.5	18.2	5.4	10.1
Flexible Portfolio	10.1	8.9	3.7	6.6
General Bond	5.4	6.4	6.6	5.6
Int'l Fixed Income †	2.8	5.7	4.4	5.0
High-Yield Taxable Bond †	13.1	10.8	8.5	7.8
General Municipal Debt	3.6	5.7	5.1	3.9

* Source: Lipper, as reported in the online *Wall Street Journal*, June 8, 2013.
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.

Corporate Home Teams Are Really Getting Around

Global diversification has been a consistent theme on these pages over the past three decades. And as far back as 1999 we noted that many of our most familiar publicly held companies were garnering a meaningful share of their revenue outside the U.S.

The analysts at Capital Research & Management recently updated the importance of a company's *markets* rather than the location of its corporate headquarters. Dynamic growth in the developing world has not always meant great performance by the stocks of companies located there. But rising wealth and consumption usually represent expanding markets for products and services of leading multinationals. That trend has persisted, and public companies based in the U.S., the U.K., and Europe now get nearly half their sales outside their home borders.

CR&M suggests that specific industry and company factors now have more influence on share price. Yet investors still exhibit a degree of home-country bias. Even companies whose products and services span the globe are often painted with the broad brush of economic conditions in their home countries.

Currently this effect may be greatest with the stocks of European multinationals, many of which are priced at lower valuations, by most standard measures, than comparable competitors, especially those based in the U.S. Taking advantage of such temporary biases comes down to solid fundamental research across myriad companies, wherever they may reside, to capitalize on the world's best growth prospects, wherever they may arise. ■

The Multi-Sector Antidote to Low Yields, Higher Risk

One of the most pressing questions for income-seeking investors and their advisors is when interest rates will finally move higher and what the impact will be on fixed income instruments. There has been no dramatic move as yet, although yields have edged higher and year-to-date total returns are flat to slightly negative for mainstream, higher quality sectors of the bond market.

Again, diversification may be part of the answer. The most widely followed benchmark for U.S. investment grade fixed income, the Barclays U.S. Aggregate Bond Index, accounts for only about 39% of the world's investable fixed income opportunities. Despite its average yield to maturity of only about two years, it is estimated that a 1.00% rise in the Barclays Aggregate yield would imply about a 5.3% decline in the price of its underlying instruments.

Trends in the global economy, markets, and monetary policy have prompted – necessitated, really – an expansion of investors' fixed income horizons. More attractive sectors have included high yield (lower rated) bonds, syndicated bank loan funds, and emerging market debt.

Not long ago, emerging market fixed income plays were largely in sovereign (government) debt, but there has been dramatic improvement in the balance sheets of both emerging market governments and corporations. A number of these countries exhibit more robust growth and lower overall debt levels than many developed nations. About 95% of emerging market sovereign debt is now rated investment grade, along with 73% of emerging market corporate issuers.

Piecing that all together can be a challenge. One approach is represented by multi-sector income funds, a category that started building out about 25 years ago and now includes a number of players with credible long-term track records. But even some of these funds with the strongest five- and ten-year results are struggling to stay in positive territory this year.

The exact shape, timing, and extent of any resurgence in interest rates will be difficult to call, and different types of income generating securities are bound to react differently. The accompanying table provides a recent snapshot of yields (not total returns) for some of the sectors that managers have employed to raise portfolio income and *diversify* risk. After all, each of these alternatives carries its own risk/return profile. Even the most varied smorgasbord is subject to that overarching rule about free lunches. ■

Snapshot of Recent Yields on Income Alternatives *

Asset Class	*Representative Index - Yields Quoted as of 3-31-2013*	*Yield*
Equities	Standard & Poor's High Yield Dividend Aristocrats	2.92%
REITs	Dow Jones Global Select Real Estate Securities	3.58%
Fixed Income	BofA Merrill Lynch U.S. Diversified Crossover Corporates	3.72%
Fixed Income	BofA Merrill Lynch Emerging Markets Diversified Corp.	4.07%
Hybrids	Barclays U.S. Convertible Bond > $500 million	4.41%
Fixed Income	Standard & Poor's Municipal Yield	5.05%
Fixed Income	Barclays Emerg. Mrkt. Local Currency Govt. Diversified	5.11%
Fixed Income	Barclays U.S. High Yield Very Liquid	5.42%
Hybrids	Wells Fargo Hybrid and Preferred Securities Aggregate	6.22%
Equities	Standard & Poor's Emerg. Mrkt. Dividend Opportunities	7.76%
Equities	Standard & Poor's International Dividend Opportunities	7.87%

* *Source:* **Barclays, FactSet, State Street Global Advisors**
Yields shown above do *not* represent total return for any particular time period. Total return for any time period may be greater or less than the indicated yield, and could in fact be negative. Indexes are unmanaged and any return and\or yield figure does not reflect the deduction of fees or expenses.

► *continued from page 1...* *Returns Look Good...*

than 10% actually appear to have been *less* frequent. Daily volatility was a little greater, but only for a short period.

Not surprisingly, 2008 was the most volatile year by far. Subsequent years were about average, and 2012 showed *below* average volatility. The 1990s were calmest decade, with most of the volatility to the upside and mean standard deviation of just 0.79%. The 2000s were the rockiest with a 1.29% standard deviation. That means that two-thirds of all trading days saw less fluctuation than that, and on 95% of the days the movement was less than 2.6%.

There are many factors inflating our perception of volatility. With indexes at historic highs, just the average daily percentage move involves a lot more points than it used to. There's heightened media coverage with its propensity to overdramatize whatever the day's financial news may be. Add to that the explosion of social networking, and it can be pretty challenging to stick to a disciplined strategy.

Then there's that age thing. For boomer-generation investors nearing or already in retirement, the prospect of weathering another significant bear market is discomfiting at best. But that's largely an asset allocation question. It's perfectly sensible to limit market exposure for the capital you will rely on for income in the near term.

Despite the emotional challenge, volatility is a cost of opportunity. If stock prices simply marched forward in equal daily increments, their returns would soon coalesce around the levels of the least risky investments. It's part of the deal. ■

Cheeseheads Rule! While the Folks Next Door Struggle

Who says we can't learn anything from government – or at least *some* governments?

The Wisconsin Retirement System (WRS) is considered one of the nation's best run, thanks in part to a bit of "hard cheese." For five straight years many retired firefighters, police officers, teachers, and other state and municipal employees have seen cuts in their pension income due to a unique provision for sharing the risk *and* reward of the system's investment performance.

Like most pension funds, Wisconsin's took a hit in 2008. The ongoing adjustment to that reality has spread about a $4 billion cut in payouts over five years. This year's reduction alone is as much as 13% off last year. But pensioners also can see "bonuses" when returns are strong – as much as 17% in 1999.

This flexibility has helped keep the WRS close to full funding, while a Pew Center study last year reported that total U.S. public pensions were *underfunded* to the tune of $757 billion. Burden sharing got another boost when Wisconsin started requiring municipal employees to split the cost of their employers' required contributions to the WRS. The state still covers 76% of system contributions, but cost-sharing on the remainder gives taxpayers some added insulation.

If America's Dairyland is the exemplar of prudent pension policy, one need only gaze southward to the Land of Lincoln for a contrasting picture of profligacy. Illinois now features the nation's worst pension funding crisis amidst a larger fiscal mess. The state is having to slow-pay thousands of vendors, and the federal Securities & Exchange Commission (SEC) recently cited Illinois for fraudulently misrepresenting its financial situation in its bond offerings to investors.

Clearly, these two states have made some contrasting choices over the years, from which investors may draw some useful reminders. For example, failing to use time to good advantage can often lead to desperation; deferring gratification isn't easy, but it is essential; and for governments as well as individuals, realistic expectations and practical, measured responses to unpleasant surprises are among the hallmarks of *adult* behavior. ■

President's Proposal Points Up the "Price" of a Comfortable Retirement

President Obama recently suggested capping Americans' tax-deferred retirement accounts, or the present value of the benefits from such plans, at $3 million. The American Society of Pension Professionals & Actuaries quickly pointed out that the president's own projected retirement benefits, based on reasonable actuarial assumptions, would carry a present value of at least *$5 million*.

Hey, it was just a proposal. But it does help illustrate a pair of noteworthy trends. Most Americans can no longer look to a stream of retirement income from a traditional defined benefit pension plan. Their accumulated IRAs, 401(k)s, and similar plans will need to support the lion's share of their retirement income. Meanwhile, today's ultra-low interest rates and long retirement time horizons have boosted the size of the base needed to sustain a financially secure, active retirement.

For reference, a sixty-five-year-old man, seeking $100,000 annual income for life from a simple immediate annuity would need to pay an insurance company nearly $1.5 million. And that's without any inflation protection or survivor benefit. Secure income has become pretty darned expensive.

That $3 million cap is actually an extension of some other nips and tucks the president proposed to trim the retirement savings tax advantages available to higher income earners. But no such provisions have been enacted, and the administration and Congress appear to have more pressing business. So for now the strategy would appear to be to take full strategic advantage of those tax benefits as long as they're available. Retirement probably won't be getting any cheaper. ■

Working Past 65? You Still May Need to Enroll in Medicare

If you are 65 or older and working for an employer who provides health insurance, it *still* may be important for you to sign up for Medicare. Medicare rules *require* enrollment for those over 65 who are *not* covered by an employer's health plan that covers at least 20 employees. Failing to enroll can accrue a late-enrollment penalty when you do eventually sign up equal to 10% of the Part B premium for every 12 months you delayed enrolling.

The basic Part B premium for 2013 is $104.90, or higher for those with modified adjusted gross income over certain thresholds ($85,000 single, $170,000 joint). Failure to sign up could also truncate your other coverage. That's because Medicare is the primary payer for those over 65 who aren't under a plan covering 20 or more employees. Health insurers generally will not pay a claim for such an individual until Medicare has paid its share (generally 80% of the bill). But the person must be enrolled in Medicare for that predicate payment to occur.

You may feel your current coverage is "better than Medicare," but it's best to double-check on exactly where you stand with respect to the enrollment requirements. You may or may not be able to retain your current coverage as supplemental insurance, or you may want to shop around for alternatives. ■

Is Technology *Serving* Investors, or Just Distracting Them?

Technology certainly can help us stay abreast of portfolios and market developments, but has it made us better investors? Not necessarily, according to an online survey by insurer Northwestern Mutual.

Of the of 1,546 technology users surveyed, many reported being increasingly distracted by technology, especially the onslaught of electronic messages and data. Baby boomers and older investors in particular noted difficulty in staying focused on long-term goals and disciplined strategies amidst all that noise.

Being able to check your investments easily online *should* be a source of reassurance rather than consternation. A well-diversified portfolio is typically less volatile than the market averages that dominate headlines. Simply observing the complementary behavior of different components of your portfolio can help reinforce the logic and effectiveness of your investment approach. Financial news coverage, by contrast, tends to favor breathless rhetoric, conflicting opinion, and exaggerated charts. It is, after all, a part of the entertainment world designed to profit from, rather than mitigate, the fear-greed cycle.

Real knowledge is power, and it also should contribute to peace of mind. If you would like to take fuller advantage of online access to your investments, please check with your KMS Representative. ■

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A Reprieve on the Budget, For Now

Six months ago, with the "fiscal cliff" looming large, these pages suggested that "with modest but sustained growth, another extension of current income tax rates, restoration of the full payroll tax rate... and continued restraint on spending growth, the [federal] deficit could slip somewhere below 6% of GDP."

Well, that's roughly what Congress and the president settled on, and now it looks like we weren't optimistic *enough*. The Congressional Budget Office (CBO) reports that for the first eight months of fiscal 2013, federal revenues are up 15% versus a year ago while spending is flat (remember the sequester?). With two-thirds of the fiscal year gone, the deficit is $627 billion versus $844 billion a year ago.

More remarkably, with two quarterly tax payment months (June and September) left in fiscal 2013, the CBO projects that federal revenues will roughly equal outlays over the last four months of the year. That would reel the full-year deficit in closer to 4% of gross domestic product. For good or ill, it kind of takes the heat off the old budget crisis, at least for the time being. ■

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