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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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Keeping the Pump Primed at the Fed

Once upon a time, QE2 referred to a British monarch or an ocean liner. Now it's shorthand for the Federal Reserve's new round of "quantitative easing." The Fed announced plans to buy up to another $600 billion of U.S. Treasury securities at the rate of $60 billion or so per month – roughly equal to the government's *monthly* net new borrowing these days.

The Fed wants to ensure strong market demand for U.S. Treasury issues to keep those benchmark yields at their current super lows. Maybe then more capital will flow to other assets, bank lending, etc. Of course it's not clear that businesses generally crave more credit, and the tiny yields on the highest quality debt instruments already have helped fuel what some see as a speculative surge in global stock and bond markets and a cross-section of commodities.

Markets rallied on the Fed's announcement, but skeptics abound. The Fed has pumped lots of liquidity into the financial system. Bank reserves are up almost 14% over the past year and are well above levels required to support deposits. Investors and businesses may be comforted to know the Fed won't tighten soon, or concerned that it still sees the recovery as so weak. As the accompanying table shows, some faster growing economies already face the possibility of overheating.

Liquidity Flowing to Asian Nations

YTD thru 11-28-2010...	Currency vs US $	Stock Mrkt Index	Inflation
India	+ 1.3%	+ 9.6%	8.6%
China	+ 2.4	–12.4	4.4
S. Korea	+ 0.9	+13.0	4.1
Thailand	+10.2	+35.0	2.8
Philippines	+ 5.3	+32.8	2.8
Indonesia	+ 4.7	+43.7	5.8
Malaysia	+ 8.6	+17.2	2.0
Singapore	+ 6.5	+ 9.0	3.5
Australia	+ 7.4	– 5.6	2.8

Source: *Wall Street Journal* Market Data Group

New Fed purchases will target longer term Treasury bonds which could help contain those yields and discourage the low-risk trade by which banks raise funds at near zero cost and buy longer term Treasury bonds to net a 2.5%–3.5% yield margin. But QE2 would have to drive a significant drop in yields to dim the lure of that trade in an environment of slack loan demand and deep risk aversion.

Given the Fed's previous interventions, QE2 raises the specter of inflation down the road. After a period of very slow growth in the money supply, standard measures showed a marked late-summer pickup in the pace of money getting into circulation. Reserve requirements for banks also jumped, suggesting that the flood of liquidity is affecting the economy.

If standard measures of money supply growth (M1 and M2), bank lending, and inflation continue to tick up, the Fed could elect to curtail QE2. Investors have to hope Mr. Bernanke and his colleagues can pull the right levers at just the right time. ■

One Relative Bright Spot: U.S. Exports

President Obama recently issued an executive order for the government to use "every available resource" to support a doubling of U.S. exports over the next five years. He didn't specify any policy changes or legislation to that end, but it looks like the Administration is ready to seek ratification of a free trade agreement negotiated with South Korea nearly four years ago.

U.S. exports have grown nicely in any event. As the president issued his order, U.S. companies had just logged 18% growth in exports of goods and services for the trailing 12 months. A weaker dollar and stronger recovery in other parts of the world helped drive those gains.

Before the latest phase of the euro zone debt crisis, the dollar was weakening again against most major currencies, even China's closely controlled yuan. Since 2000 the greenback is down 67% against the euro, 17% against the British pound, 22% against the yen, 34% against the Canadian dollar, and 20% against the yuan. That cumulative change over time has helped American companies gain some pricing edge.

The U.S. has never really been out of that game; export growth has averaged about 7% per year since 1960. Recent numbers also refute the canard that "America doesn't make things anymore." Exports of goods have been growing notably faster than services. The biggest gains have involved global sales of industrial supplies and capital goods, especially transportation and earth moving equipment.

November marked the 16th straight month of expansion in manufacturing, based on the Institute for Supply Management's factory index. But manufacturing employs only about 9% of U.S. workers, and exports account for only 12% of

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Bonds Have Been Popular, but History Likes Stocks

Until lately this had been a rewarding year for bond investors. Interest rates fell as economic worries persisted. Bond holders reaped some income and appreciation while stocks seemed to just gyrate. The three-year look-back made bond investing look especially favorable against most equity fund results.

But the folks at Morningstar recently updated the long-term story on comparative performance of bonds versus stocks. The financial research firm went back to January, 1926, and looked at rolling five-year, 10-year, and 20-year periods from that point through last May. For a very high percentage of the rolling 10-year and *all* of the 20-year periods, stocks were the better bet.

However, with retirement and other critical needs in the balance, this isn't a casual call. History may favor equities, but it also argues for caution and balance. Given a reasonable time frame, prospects for a rewarding result from equity investing appear to be encouraging, but one must also consider the *cost* of an uncharacteristically adverse result.

There are a couple of key components to a prudent investment decision. One is a reasoned assessment of the odds of success. The other is a realistic assessment of whether one can afford failure. History can help with one of those components, but not so much with the other. ■

Investment Performance Review	**TOTAL RETURN *** **(dividends and capital gains reinvested)**			
Selected Mutual Fund Categories *	**--- Annualized thru Dec. 3, 2010 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	12.0%	– 4.0%	1.2%	1.4%
Mid-cap Stocks (Core)	25.0	– 0.4	3.2	5.4
Small-cap Stocks (Core) †	28.2	1.1	3.0	7.8
Foreign Stocks (multi-cap) †	7.8	– 6.6	3.8	5.5
Emerging Market Stocks †	17.7	– 5.3	11.2	15.4
Natural Resources	22.4	– 3.9	4.9	10.3
Real Estate related	31.4	– 2.4	1.4	9.9
Flexible Portfolio	10.4	0.1	3.5	4.3
General Bond	6.3	4.5	4.8	7.0
Int'l Fixed Income †	2.1	5.8	6.4	6.9
High-Yield Taxable Bond †	15.5	6.6	6.5	7.1
General Municipal Debt	3.8	3.1	3.2	4.2

* Source: Lipper, as reported in the *Wall Street Journal*, Dec. 4, 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.

Social Security and Retiree Income Needs

President Obama's deficit reduction commission recently released its laundry list of proposals for reining in a federal deficit that has ballooned over the past three fiscal years. Hopes of narrowing that gap over time will confront a rising tide of entitlement spending. The evolving shape of Social Security is central to the debate, and it's also important to folks planning for their retirement.

Replacing Income In Retirement		
Pre-retirement Gross Income	Avg. Retirement Income Need	Avg. Provided by Social Security
$ 40,000	$ 34,000	$ 21,600
$ 60,000	$ 46,800	$ 27,600
$ 80,000	$ 61,600	$ 31,200
$ 90,000	$ 70,200	$ 32,400
$150,000	$126,000	$ 34,500
$200,000	$172,000	$ 34,000
$250,000	$220,000	$ 35,000

Source: Aon Consulting; Georgia State University

Ten years ago the *Quarterly* looked at the role of Social Security in providing for retiree income needs. The accompanying update to that overview is drawn from the latest annual study on retirement income replacement conducted by Aon Consulting and Georgia State University. It is based on 2008 numbers from the Commerce Department's Bureau of Labor Statistics, the latest data available for such comprehensive analysis.

The table points up some cogent realities, including how crucial Social Security benefits are for those with more modest pre-retirement levels of income. This reflects the progressive aspect of Social Security's basic design. Those with more modest income over their work history receive significantly higher benefits *relative to the payroll taxes paid in on their behalf*.

For retirement planning the numbers also amplify the acute need for upper income earners to accumulate additional retirement resources. Some may be fortunate enough to benefit from traditional pension plans, but more and more individuals must look to their own savings accumulated through IRA and 401(k) contributions plus other long-term investments.

As for future changes to Social Security, that's anyone's guess. Based on the proposals emanating from the deficit commission, one can probably assume that any such changes will *not* favor those at the upper end of the earnings curve. ■

New Tax Reporting Requirements for Brokerage Accounts

The New Year brings some changes on the tax front for brokerage firms and accountholders. Starting in 2011 federal law requires firms to report an investor's cost basis to the Internal Revenue Service after the investor sells a stock. Cost basis is the price of acquiring the investment and the starting point for figuring taxable gain or loss.

Trickier than it sounds: Tracking cost basis can be complex, especially when there have been multiple purchases, splits, or reinvested dividends. Without conducting in-depth audits, it has been difficult for the IRS to know whether taxpayers were correctly reporting gains and losses. Politicians suggest an annual revenue shortfall of as much as $25 billion due to inaccurate gain/loss reporting. That's a bit of guesswork, but a couple years ago Congress mandated that investment providers would have to start tracking clients' cost bases and report them to the IRS on form 1099-B when an investment is sold.

Account providers will have to track stock splits, reinvested dividends, and mergers, as well as inherited or gifted investments. And they'll have to adjust for "wash sales" (buying a security 30 days before or after a sale of essentially the same position). Providers must adjust cost basis for investments with matching CUSIP numbers within one account, but they needn't look to accounts at different firms or even different accounts at one firm, although the taxpayer must do so.

Phasing in the rule: The new rules kick in first for sales of stocks and real estate investment trusts purchased after January 1, 2011. They clock in for mutual fund sponsors and dividend reinvestment plans (DRIPs) January 1, 2012. Some exchange-traded funds (ETFs) fall under the requirement starting in 2011, others in 2012. Individual bonds and options are included starting January 1, 2013.

Choices to make: Account holders should make some decisions soon about their securities sales in taxable accounts. The IRS has published over 100 pages of rules pertaining to the new law, but the key issue for most investors is the selection of tax lots when selling "covered" positions. That choice must be made at time of trade and cannot be changed after settlement day of the transaction. That applies to gifts or transfers of shares as well.

For accounts held with KMS' primary custodian, Pershing LLC, the default disposition method will be first-in-first-out (FIFO) for shares of stock, or the average cost method for mutual funds. However, there are other methods available, so you may want to check with your Representative regarding your preference.

One more note: Determining the tax effect of a transaction is ultimately between you and the IRS. Brokerage firm reporting can only reflect information gathered by or provided to the firm. It may not reflect your total holdings or acquisition history for a security. Be sure to consult with your tax professional on such matters. ■

Trying to Guess Next Year's Tax Rates? Does It Really Matter?

At this writing, trying to project next year's marginal tax rates, especially for affluent taxpayers, is still a guessing game. A lame duck Congress, with lots of members having been retired by voters, struggles to reach some compromise on whether, and for whom, the so-called "Bush tax cuts" will be preserved. It's a political headline grabber, but for most of us weighing typical year-end investment and financial decisions, it may not make a great deal of difference.

For example, making a tax-deductible **contribution to an IRA or qualified retirement plan** probably makes sense in 2010 even if your 2011 marginal rate turns out to be a little higher. You'll realize the benefit sooner when you file your 2010 return, and you'll have a whole year to figure out how to maximize such opportunities for 2011.

The **municipal bond** market has had a rough ride lately, and some of that has been attributed to uncertainty over the relative value of tax-exempt interest next year and beyond. But that's only one factor in the pricing of munis, and probably not the main one. Concerns over credit quality, market liquidity, and the general direction of interest rates may be having greater effect than the potential difference of a few percentage points in the top individual tax rate.

Charitable contributions are another item where one might be tempted to hold off on the theory that the deduction may be a little more valuable next year. That might make sense for a large, once-in-a-blue-moon gift. But for most of us, putting off a gift until we really have a good handle on our 2011 taxes means putting it off for months – maybe until next year-end. Your favorite charities probably need the money at your earliest convenience.

Giving appreciated securities is often a savvy tax strategy, and may be even more attractive if the 15% capital gains rate rises significantly. But that's not really a reason to delay a gift that you've already earmarked. After all, those securities could *depreciate*. More to the point, a charitable deduction is based on the value when given, not the after-tax amount one would net from selling the asset instead.

Legendary Green Bay Packers coach, Vince Lombardi, famously remarked, "Winning isn't everything, it's the *only* thing." But when it comes to investing and financial planning, taxes *aren't* everything, nor are they the *only* thing. ■

RMDs Are *Back*!

It wasn't so long ago – 2009 in fact – that taxpayers were given a holiday from IRA Required Minimum Distributions. But RMDs are back for 2010, and year-end looms.

IRA-holders who turned 70½ in 2009 (or earlier) must take a distribution by December 31, 2010, based on the IRA's value at 12/31/2009. IRA-holders turning 70½ in 2010 have until April 1, 2011, but that bundles both 2010 and 2011 RMDs into the same tax year. One might rather get 2010's out by year-end.

The penalty for failing to take the RMD is steep: 50% of the amount that should have been distributed. Interestingly, there is no requirement to "make up" for a missed RMD; there's just the penalty on what *should have* come out.

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U. S. Exports

gross domestic product. Strength in that sector hasn't really reverberated across the rest of the economy.

Nevertheless, it's a smart politician who sees a chance to jump out in front of a passing parade. Competitiveness will be critical in meeting our fiscal and economic challenges. Recognition of that in high places is always welcome. ■

It's Still Kind of Tough Out There – Just Ask Mr. Goodwrench

There have been *some* encouraging statistics on the jobs front, but it's still a difficult environment. If an unemployment rate stuck stubbornly above 9% isn't enough to make that case, consider the sad news that General Motors is letting Mr. Goodwrench go.

Goodwrench (anyone know his first name?) is a GM icon, having represented the auto giant's dealer service and repair programs for much of the past four decades. He did suffer through an extended layoff starting in the 1990s, but he was rehired in 2008, looking younger and fitter than ever, to help turn around a company in crisis.

Despite those efforts, 2009 brought a government rescue of once-proud GM. With Uncle Sam in the driver's seat it was probably inevitable that the company would seek a more gender-neutral image. And in a world of high-tech driving machines and computer diagnostics, no auto company wants to suggest that someone might have to take a "wrench" to the product.

Soon enough we'll be bidding a fond adieu to Mr. G. For now, well-wishers can still connect with him at *www.goodwrench.com*. ■

Finally, with the hype surrounding Roth IRA conversions, you may wonder if a Roth conversion counts toward the RMD. The answer is no. An RMD must be taken *in addition to* any amounts one decides to convert to a Roth. Sorry. ■

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

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