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Nations Pledge to Play Nice with Their Currencies

Finance ministers from the "Group of 20" met recently and pledged *not* to pursue competitive devaluation of their respective currencies. In other words, competitive devaluations are a real possibility.

In recent years the U.S. dollar's relative weakness against the yen and the euro exacerbated economic challenges in those countries. U.S. exports gained, our economy appeared to find its footing, and our markets have rallied. Federal Reserve policy obviously has played a role with its large purchases of Treasury and mortgage-backed securities helping to hold short-term yields on "safe-haven" securities near zero and long rates at historic lows.

Nations that are especially sensitive to dollar weakness would probably prefer to see the Fed let rates rise. Last fall Japan's central bank launched an effort to stem the yen's appreciation. Japan has long been a formidable exporter, but it's also a high-wage producer with unfavorable demographics and a mountain of government debt. It could not stand by and watch its exports lose their price competitiveness.

Now China is expressing displeasure with Japan's success at cheapening the yen. The Chinese are equally keen on maintaining the competitiveness of *their* exports. As for Europe, many analysts feel the euro is overvalued and that a pullback would help that continent's sluggish economies.

Meanwhile, the dollar draws support from its status as a safe haven and the world's reserve currency. Inflation remains subdued, so the Fed can continue its historic monetary accommodation, and the U.S. continues to post improved economic numbers.

Returns for traditional inflation hedges like precious metals and commodities have ranged from paltry to punishing for more than a year. Natural resource stocks languished last year but have strengthened recently with improving economic prospects. To the extent some of these sectors have slipped below their target allocation in investor portfolios, this may be a window of opportunity for some rebalancing.

There are also friendly, resource-rich countries such as Canada and Australia, as well as fast growing emerging nations, whose debt levels are modest and whose currencies may hold up well. The risk-averse, post-crisis environment has favored the familiar in investors' minds. But with so many developed countries trying to keep a lid on their currencies, the stocks and bonds of those faster growing, lower-debt players may catch a tailwind.

Trying to time the gyrations of one currency against another is notoriously tricky. But gradual devaluation of major monetary units (inflation) has been a long-term trend. If one looks only in the rear-view mirror, some of the asset categories mentioned above may lack appeal. But strategic investing involves considering what may lie just over the horizon, and making periodic, measured adjustments. ■

Turning Up the Heat Within Those Hallowed Halls of Ivy

Eighteen months ago we delved into the rapid rise in college tuitions over the past 40 years and noted that more folks were starting to question the relative value of the product. This issue has picked up steam lately. Democratic senator Ron Wyden from Oregon and Florida Republican Marco Rubio have teamed up on legislation to require states to provide more access to information on college graduates' earnings.

Pressure from politicians is understandable, if a little ironic. Federal tuition assistance to students, primarily in the form of Pell grants, doubled from 2008 to 2010 before being pared back a bit under current budget pressures. Even so, it represents more than half of the Department of Education's total spending authority. Lawmakers were bound to ask whether the multi-decade surge in that support has truly enhanced learning opportunities or just propped up prices for a higher education establishment that's been a little slow to innovate.

Yet innovation is in the wind. The University of Wisconsin recently announced a new program to award bachelor's degrees based on knowledge demonstrated through testing and online courses with *no classroom time required* in some cases. Colleges are sponsoring MOOCs – massive open online courses – while still groping for ways to monetize participation and reliably assess student performance.

Both the timing and the clientele may be ripe for a little rebellion. Most parents of today's undergrads did *their* matriculating in the early-to-mid-1980s. They've spent their working lives in a world of modest inflation and incremental wage gains. Now they face tuition costs

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Kind of the Way It's Supposed to Work

Maybe it was the fact that equity markets produced a pretty nice return in 2012; or that the year-end compromise on the fiscal cliff averted the worst-case scenarios; or that while euro zone economies continue to struggle, the monetary union hasn't been ripped asunder. Whatever the reason, investors started the year by embracing risk at a level not seen for some time. Flows into equity mutual funds during the opening weeks of the year were the strongest in at least a decade.

That turn was pretty sudden, and February fell back into a tug of war. But maybe we're getting used to these muddle-through scenarios. It's a similar picture in the euro zone as long as Germany stays patient and the European Central Bank accommodating. A pick-up in global growth is helping, and China seems to have kept its locomotive chugging despite forecasts that it might falter. Japan's leadership is pushing on the monetary strings to try to revitalize that economy.

Meanwhile, the U.S. seems to have found a way forward with fairly broad improvement in housing sales, new construction, manufacturing, business investment, and the big surge in oil and gas production. These are welcome counters to the weight of higher payroll taxes and gasoline prices. It's not exactly the "new era" excitement that had folks margining everything but the kitchen sink to buy tech stocks in the late 1990s. But it does look a little more like a path to a future – what investors need to see to reach out to equities and other assets that carry some risk.

As the investing world reacquaints itself with that frontier, we might take a look at the attached Investment Performance Review, and particularly the 10-year column. We tend to think of the past decade as a minefield of geopolitical strife, protracted military engagements, nerve-wracking market volatility, financial crises, and unprecedented fiscal and monetary responses. Yet the 10-year returns for those major categories of mutual fund portfolios have a familiar ring.

Consider that since 1925 annualized inflation has run just under 3%. Quality bonds have generated three to four percentage points above that, while the broad U.S. stock market provided about a seven-point annualized premium. The past decade's inflation was a bit lower, but the "real" (above inflation) returns across the relative risk spectrum appear to be pretty much in line with those much longer term averages. Maybe the past decade wasn't such an anomaly after all. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru March 7, 2013 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Core)	15.5 %	11.1 %	4.8 %	8.0 %
Mid-cap Stocks (Core)	16.2	12.5	6.8	10.5
Small-cap Stocks (Core) †	16.7	12.8	8.0	11.3
Foreign Stocks (Multi-cap) †	13.1	5.6	– 0.5	9.1
Emerging Market Stocks †	6.0	4.5	0.0	16.1
Natural Resources	5.9	6.7	– 0.6	12.5
Real Estate Related	16.8	17.8	7.4	11.5
Flexible Portfolio	5.9	7.3	4.3	7.8
General Bond	6.2	7.1	6.8	6.4
Int'l Fixed Income †	2.8	4.5	4.2	5.7
High-Yield Taxable Bond †	11.8	10.4	9.3	8.7
General Municipal Debt	6.4	6.5	5.6	4.3

* Source: Lipper, as reported in the online *Wall Street Journal*, March 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.

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Turning Up the Heat...

that, even adjusted for inflation, are nearly three times what they paid back in the 1980s. And these folks' memories are still pretty good.

This is also the cohort that has driven a revolution in communications technology and the democratization of access to information. By their lights, our citadels of higher education may be starting to look a little anachronistic, at least as a productivity model. Many recent grads are struggling as well. The Federal Reserve Bank of New York reports that 35% of student-loan borrowers under 30 were at least 90 days late on payments at the end of 2012. That's up from 26% in 2008 and 21% in 2004.

There is great intrinsic value in a true education, and it defies measurement in terms of productivity or the securing of future financial rewards. But for years those kinds of material considerations have been actively promoted to rationalize ever higher *real* costs of a bachelor's degree. What's that old saying about those who "live by the sword"?

In support of the legislation he is sponsoring, Senator Wyden notes the need to "introduce some market forces into the academic arena that have not been there." Politicians do develop the instinct for getting out in front of a parade before it passes them by. You may want to grab a good viewing spot along the route; this could be fun to watch. ■

Taxpayer *Relief* ? It's Complicated...

Surveying the American Taxpayer Relief Act (ATRA) passed around the New Year, you may wonder, where's the relief? Just about anybody who earns anything got some kind of tax increase. But it could have been worse. The newly restored 39.6% income tax bracket and 20% rate on dividends and capital gains formally apply only above the rather rarified income levels of $450,000 for joint filers ($400,000 single). However, below that fold a much larger cohort will find themselves with stealth marginal rate increases as they experience one or more of the following provisions.

• **Phase-out of Personal-Exemptions:** Above an Adjusted Gross Income (AGI) of $250,000 (single) or $300,000 (joint), personal exemptions are reduced by 2% for every $2,500 above the threshold. In other words, a family of four with $400,000 of AGI loses 80% of their $15,600 in personal exemptions, resulting in $4,368 (4.37%) of added tax on that last $100,000 of income.

• **Limit on Itemized Deductions:** Above those same thresholds, the value of some of the most common itemized deductions (e.g., mortgage interest, charitable gifts, state and local taxes) is reduced by 3% of the amount by which AGI exceeds the threshold, to a maximum reduction of 80%. So, our family of four with $400,000 of AGI and at least $3,750 of subject deductions sees them trimmed by $3,000. That's another $1,050 (1.05%) of tax on that last $100,000 of income.

And there's more. The following measures were already on deck with or without ATRA.

• **Medicare Tax on Earned Income:** The Medicare Tax is increased from the regular 1.45% to 2.35% on wages or self-employment compensation above $250,000 (joint filers) or $200,000 (single).

• **Medicare-related Tax on Investment Income:** A new 3.8% tax is levied on dividends, cap gains, etc., to the extent a taxpayer's AGI exceeds $250,000 (joint) or $200,000 (single). We examined this odd specimen in our *Winter* issue.

If you were hoping for some simplification from this round of tax tinkering, well, maybe some other time. For now the simple message for households in the income ranges outlined above is to pay a little closer attention to how you take that income, and to the added incremental value of strategic tax *deferral*. You might also expect a little higher cost for tax preparation next year. Think of it as the "ATRA-Fee." ■

...But Helpful on the Estate Tax Front

Nearly all the news coverage surrounding the American Taxpayer Relief Act was directed toward changes in top marginal income tax rates. But the legislation did provide some relief from uncertainty on the estate tax front by essentially adopting the system in effect the past two years and a modest bump in the maximum federal estate tax rate from 35% to 40%. Here's where things stand now.

ATRA retained the basic exclusion amount of $5 million per person in estate value, which had been indexed to inflation. In 2012 it rose to $5.12 million, and the IRS recently announced an exclusion of $5.25 million for deaths occurring in 2013. There's still an unlimited deduction that postpones the estate and gift tax on assets inherited from one's spouse, assuming the inheriting spouse is a U.S. citizen.

The 2010 law had another valuable feature that has been retained. Widows and widowers can add any unused exclusion of the spouse who died first to their own. This "portability" enables a couple together to transfer up to $10.5 million to their heirs with no federal estate tax.

But it isn't automatic; the executor for the estate of the spouse who dies first must transfer the unused exclusion to the survivor, which requires the filing of an estate tax return at that juncture even if no tax is owed. A surviving spouse probably should file a return even if he or she is not wealthy today, because who knows what the future holds? And depending on one's state of residence, there may still be a role for a credit shelter trust or other estate planning vehicles.

Finally, the most important advice is to work with a qualified estate planning professional to craft a will and any other documents that may be called for. Every situation is unique in some way, and there certainly isn't room in a four-page newsletter to address all the potential issues and contingencies. ■

Playing Peek-a-Boo with Charitable IRA Distributions

Now you see it, now you don't. That's the history of a special tax break for seniors who direct their IRA distributions to charity.

The American Taxpayer Relief Act of 2012 (ATRA) restored these Qualified Charitable IRA Distributions (QCDs). Clients who are 70½ or older can (once again) make gifts of up to $100,000 directly from an IRA to public charities and exclude those distributions from taxable income. The provision applies for tax years 2012 and 2013.

This opportunity mostly benefits seniors who do not itemize deductions and would rather see some or all of their required minimum IRA distributions go to charity than book them as taxable income.

By the way, if you are over 70-1/2, and you made a 2012 IRA distribution direct to a qualifying charity without *knowing* you'd get a tax break, congratulations. You can exclude that distribution from your 2012 return. But keep good records, because your IRA custodian will likely report the distribution just like any other. If you have questions, check with your tax advisor, your KMS Representative, or perhaps your member of Congress. ■

Taking Stock in Our (or at least somebody's) BRAIN Power

A few years ago the really hot investment theme was called BRIC, which stood for Brazil, Russia, India and China. Results have been rather mixed. These days the economists at BCA Research are suggesting a new theme – BRAIN – which stands for companies at the cutting edge of Biotech, Robotics, Artificial Intelligence, and Nanotechnology.

Part of the underlying rationale is that we've been getting smarter for a long time, and technology is emerging to accelerate that process. The nightly news may prompt you to question the first part of that premise, but researchers have uncovered strong evidence that gains in human intelligence really took off about 10,000 years ago and have continued at a healthy pace ever since.

Theories abound as to the primary drivers. Rising agricultural productivity improved nutrition, expanded trade, and created the time and wherewithal for advances in literacy. The rise of agrarian societies facilitated urbanization, specialization, and sophisticated commercial and technological advances.

Selective genetic pressures were altered as well, and the resulting surge in population raised the number of potentially favorable genetic mutations. Research indicates that IQ is roughly as inheritable as height. After long millennia on the edge of subsistence, human living standards began to rise dramatically a few hundred years ago. We were finally cashing in on those cumulative gains in intelligence.

Apparently it didn't end there. Psychologist James R. Flynn documented widespread increases in IQ scores through much of the twentieth century by several points per decade. Unfortunately, some studies indicate that the effect might be fading, at least in highly developed countries. But it's reasonable to expect that it could have considerably further to run in developing countries, which would continue to enrich the global talent pool.

That brings us back to technology. Even if the rise in IQ from environmental and hereditary factors is slowing, knowledge of genomics and DNA sequencing coupled with ever faster computers may speed our ability to push nature along.

In just over a decade the cost of sequencing a human genome has fallen from $95 million to about $7,000. Computers may possess the processing power of a human brain sometime in the next decade. There are profound implications for health, education, and broad productivity gains. Social, ethical, and public policy challenges may be profound as well, but knowledge marches on.

Of course these kinds of cutting-edge technology stocks are fairly high on the investment risk pyramid. But given the market's recent preoccupation with well-known, dividend-paying companies, BCA Research considers those BRAIN stocks to be trading at reasonable valuations. Let's hope they're not *over-thinking* the situation. ■

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