KMS
Client Quarterly
Spring 2014

Compliments of

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Published March, 2014, by KMS Financial Services, Inc.
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • www.KMSfinancial.com
Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

An Echo... Probably Not a Replay

Investors may be surprised by distinct echoes of the Cold War resounding from the crisis in Ukraine. It's worth reflecting on the dynamics of that era not only with respect to Ukraine, but also regarding the historic impact of geopolitics on many emerging markets. Especially for eastern European, Southeast Asia, and some African countries, the easing of Cold War tensions helped open the door to more rapid integration into the global economy and rising living standards.

The hope, and the likelihood, is that Ukraine is but an echo of old superpower rivalries rather than a harbinger of a new era of confrontation. The sabre rattling has been pretty one-sided as Russia shows its acute sensitivity to Western defense and economic structures extending right to its border. Time will tell whether Ukraine can find its political and economic footing given its particular internal stresses that invite exploitation by outsiders.

Unlike during the Cold War, relatively few emerging nations find themselves in that vise today, Syria and Egypt notwithstanding. Ukraine at least has established an interim government that appears committed to new national elections in May. Europe and the U.S. are showing renewed interest in helping to underwrite its success. And while Russia still holds a veto on the U.N. Security Council, its voting share on the International Monetary Fund board is less than 3%; a veto requires 15%.

Perhaps it is a sign of some progress that this confrontation may largely confine itself to the economic battlefield. Russia is a key creditor to Ukraine which is a customer for Russian gas. Russia's actions in the crisis have prompted investors to unload Russian stocks and forced its central bank to boost interest rates to stem a run on the ruble. Europe depends on Russian energy resources, but U.S. policymakers have greater flexibility due to our recent surge in oil and gas production. And that's wholly a result of commercial enterprise rather than any military or strategic planning by government.

All that said, tensions and disruption in *any* emerging markets tend to raise the perception of risk in *all* emerging markets. Last year's concerns were focused on countries that looked vulnerable to the Federal Reserve's tapering. On this score, Brazil, Turkey, India, Turkey, Indonesia, and South Africa were

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A Bump in the Road for Bitcoin

It seems like bitcoin, the virtual currency, just burst on the scene with the recent collapse of Mt. Gox, a major bitcoin exchange. But it's actually been around since 2009. Of course making payments and getting paid by electronic transfer is nothing new, and bitcoin is certainly not as widely accepted as dollars. But people had been able to buy an increasing array of goods and services by sending bitcoin via the Internet from their electronic "wallet" to vendors who had established a wallet and agreed to accept bitcoin.

Those payments span the globe instantaneously with relative anonymity and *without* the interposition of a central clearing house. Merchants pay a lower fee than on most credit or debit card transactions. Bitcoin applied commonly used public-key encryption to protect the holdings and anonymity of the parties engaged in those transactions.

Some aspects of those exchanges are revealed in what's called a "block chain," effectively recording all movements of a particular bitcoin pool. Other participants can examine these chains to verify the legitimacy of transactions, and they receive new bitcoins for solving these sophisticated math puzzles (bitcoin "mining"). Nevertheless, Mt. Gox claims that hackers exploited a weakness in its system to steal nearly a half billion dollars' worth of bitcoin. Online commentaries had alluded to other cases of bitcoin theft even before that debacle.

The only record that someone owns bitcoin is on the holder's computer or with a wallet service. If either fails, the loss is like cash that's gone missing. Regulators have been monitoring to see if the system's anonymity attracts money laundering and other illicit financial activity. And at least one widely followed guru has labeled the whole bitcoin project a "Ponzi scheme."

Bitcoin fluctuates in value much more widely than major currencies. The system limits the amount issued over time and the total ultimate issuance. That limited supply and increased use had driven a dramatic rise in 2013. But there is no central, authoritative pricing, and the "currency's" run surely involved a fair bit of pure speculation.

Given its limited supply, volatility, and recent disruptions, bitcoin is unlikely to replace a major currency any time soon. But it wasn't too long ago that some questioned the Internet itself as a facilitator of commerce. Innovation in one part of the pond sends ripples in all directions. The ripples from bitcoin's plunge may be worth watching. ■

Diversification: The Long and the Short of It

This quarter's Investment Performance Review falls on the fifth anniversary of the low point of the market sell-off in 2008 and early 2009. And the numbers definitely show it, especially those for mainstream stocks and real estate related funds. Large-, mid-, and small-cap equity funds show *average* cumulative gains of about 200% over that half decade.

This reflects the dynamics of buying low and selling high. It also reminds us of a deeply disturbing time. Everyone remembers those panicky days of the financial crisis, and the way all kinds of financial assets took a drubbing together. For many it felt like the familiar strategy of portfolio diversification had "failed" in the worst way. Students of modern portfolio theory described it as "all correlations going to 1," a bit of an exaggeration but a rude awakening nonetheless.

Last year (2013) posed a different challenge to the case for broad diversification. While mainstream equities had a stellar year, several other categories struggled. Five years ago the complaint was that "diversification didn't help." Recently it may seem like diversification was just a drag.

The most frequently cited study on this issue is *Determinants of Portfolio Performance* by Gilbert Beebower, Gary Brinson, and Randolph Hood. A few decades ago they parsed the performance of 91 pension plans for the period 1974-1983 and again for 1978-1987. Both studies supported the idea that the *mix* of assets rather than individual security selection that should be a primary focus for investors.

Concentrated portfolios can, and often do, outperform their more diversified counterparts for a while. And there are times when nearly *all* major asset categories struggle together. But these tend to be short-term phenomena, and the ability to time them with repeated success is a rare talent indeed.

Returning to the numbers, the 10-year column makes the point pretty effectively. Diversification does not work *every* time, but it tends to do its work *over* time. ■

Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	--- Annualized thru Mar. 10, 2014 ---			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Core)	22.8 %	14.3 %	22.2 %	7.0 %
Mid-cap Stocks (Core)	25.2	14.2	25.6	8.9
Small-cap Stocks (Core) †	26.7	14.8	27.6	9.1
Foreign Stocks (Multi-cap) †	14.8	6.8	17.9	6.3
Emerging Markets †	– 5.7	– 1.6	16.0	9.2
Natural Resources	16.2	4.6	19.0	11.0
Real Estate Related	3.5	10.1	27.2	7.7
Flexible Portfolio	7.3	6.2	14.0	6.1
General Bond	1.3	5.7	8.2	5.4
Int'l Fixed Income †	0.5	2.8	7.0	4.8
High-Yield Taxable Bond †	6.8	7.7	17.0	7.3
General Municipal Debt	– 1.3	5.9	6.4	3.5

* Source: Lipper, as reported in the online *Wall Street Journal*, March 11, 2014.
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.

In for the Duration

The original Broadway production of *A Chorus Line* ran for 6,137 performances over 15 years. Predictions of higher interest rates and a blow-up in the bond market may eclipse that run one of these days. Yet higher rates seem inevitable, so what's the best play for the bond portion – the supposed bulwark – of a balanced portfolio?

We got a taste of the risk last year as long-term Treasury bonds dropped nearly 13% in value on a one-percentage-point rise in yields. So portfolio managers are keeping an eye on something called "duration." That's a measure that reflects the approximate percentage change in the market price of a bond or bond fund in the event of a one-percent change in interest rates.

The Barclays U.S. Aggregate Bond Index, the broadest benchmark for the fixed-income market, has duration in the range of five to six years. That indicates the index would take a 5-6% hit on a 1% interest rate move. Long-term Treasury bonds have duration of about 16 years, i.e., their sensitivity to rising rates is notably greater.

As rates rise, coupon interest can be reinvested at those higher rates. Total return is the combination of bond interest, reinvestment of that interest, and change in the bond's value. Considerable research indicates that across a wide range of interest rate change scenarios, a collection of bonds – perhaps a mutual fund or laddered portfolio – that maintains a moderate five-to-six-year average duration should see portfolio total return converge toward its initial yield if that portfolio is held for that period.

That also assumes a relatively high *quality* portfolio such as investment grade corporate or municipal bonds. The research probably didn't figure on there being many defaults in the portfolio; just moderate duration and a little patience. ■

Variable Annuities Flexing with Needs

Income guarantees gained popularity with variable annuity investors after each of the two big bear markets of the 2000s. That's human nature but not exactly ideal timing. Those contract features provide for a base level of future income even if the actual investment performance comes up short. *Awareness* of that risk tends to be greatest at market troughs, but the *odds* of such underperformance are obviously greater when the market is cresting.

A variable annuity offers growth potential through the investment accounts available to the contract holder. The insurance company pools risks across many contract holders to guarantee certain contingent living and/or death benefits. Income guarantees have evolved over the past 15 years, and it is now generally possible to secure a baseline income for life without having to annuitize the contract.

Some living benefits identify the guaranteed income amount up front; others define the base on which a guaranteed income stream will be calculated with the potential for that base to grow over time even if the underlying investments lose value.

The contract may allow the base to be "stepped up" at regular intervals, or with increases in the value of the accounts. In general, the more attractive the guarantees, the higher their underlying cost. So it's important to consider the trade-offs and the amount of income protection you feel is sufficient.

Today, the majority of variable annuities are sold with some form of guaranteed lifetime withdrawal benefit. But another traditional feature – tax-deferral – has regained traction. A year ago we covered the higher capital gains taxes and the new surtax on investment income that can affect upper-income taxpayers. This has complicated tax planning and increased the potential drag on taxable investment accounts.

The concept behind tax-deferral is fundamental: to control as much capital as possible for as long as possible. And variable annuity income guarantee is a lot like fire insurance; you buy it with the hope that it won't be needed. Of course, it's best to consider the insurance *before* the house burns down. ■

What Is this Thing Called "MyRA"?

In his State of the Union address President Obama ordered up a new government-backed, tax-favored retirement account. Whether this really *can* be created simply by executive order is an unresolved question, but for now we'll just try to describe this thing called "MyRA."

MyRAs are targeted at workers without access to an employer-sponsored retirement plan (pension, profit sharing, 401-k, etc.). Initial availability is through such employers via payroll deduction, and eventually to anyone with direct paycheck deposit and single income under $129,000 or household income under $191,000.

Like a Roth IRA, interest earned in a MyRA isn't taxed if it stays in the account at least five years. The more novel element is the underlying investment: a government guaranteed account crediting the same interest rate as the Government Securities Fund in the Thrift Savings Plan for federal employees. That particular rate has been at 2.5%, well above prevailing rates on such stable-value investments as money market funds, certificates of deposit, or U.S. Treasury bills.

However, federal employees in the Thrift Savings Plan are subject to the usual restrictions on retirement plan withdrawals, while MyRA contributors will be allowed to pull money out any time with no tax or penalty. This too is like a Roth IRA, and the same employees could certainly contribute to a Roth. In fact, a MyRA balance can be rolled to a Roth IRA any time, and *must* roll to a Roth once the balance hits $15,000.

For many workers whose employers don't offer a retirement plan, a good old deductible contribution to a traditional IRA might be a better bet. Up-front tax savings make it easier to afford the set-aside. IRA investors might end up giving back some of their tax savings if they have to withdraw money prematurely, or they might not. And having at least a little disincentive for pulling the money out can be important in building a nest egg.

In short, the only thing really *new* here is the tax-exempt, taxpayer-subsidized interest bump for a certain class of savers on a small amount of savings. Think of it as an emergency fund with an *option* to become a retirement plan. ■

Strong Markets Boost Giving

The *Atlas of Giving* reports that Americans donated $417 billion to charity in 2013, up 13% over 2012. The stock market's performance was cited as a key factor along with rising employment, real estate values, and a general rise in confidence.

Two of the country's largest donor advised funds (DAFs) reported that appreciated securities accounted for a larger share of new contributions. That's not surprising. Lots of stocks had gains, and contributing appreciated securities is a very tax-efficient way to give.

The DAF structure adds convenience and strategic planning to one's philanthropic endeavors. Assets transferred to DAF accounts generate an up-front deduction for the market value, avoiding the capital gains tax that would be due if the securities were sold. Donors retain the ability to direct future grants to the qualified charities they support.

The *Atlas of Giving* also reported a significant shift of assets by wealthier donors from family foundations to DAFs to save costs and simplify administration. Another market year like 2013 may be a tall order. But a DAF can be established with a relatively modest initial contribution, just to be ready. ■

Required IRA Withdrawals: To Wait or Not to Wait

A year ago we covered a special tax break for seniors who direct IRA distributions to charity. These Qualified Charitable IRA Distributions (QCDs) had been restored by the American Taxpayer Relief Act, but only for tax years 2012 and 2013. So what about *this* year?

The QCD provision has *not* been extended for 2014, but Congress has shown a propensity for sticking it back into the mix at the last minute. That can be a little awkward for those who dutifully take care of the required distribution early in the year, but would prefer to make a QCD if they could. Unfortunately, once you take receipt of an IRA distribution, it's a little hard to claim it as a QCD later.

Under the expired provision, taxpayers 70½ or older could make gifts of up to $100,000 *directly* from an IRA to public charities and exclude those distributions from taxable income. This was a boon to seniors who do not itemize deductions and would like to see some or all of their required IRA distribution go to a charity rather than receive it all as taxable income.

So what's the strategy for 2014 RMDs? You might consider waiting to see if QCDs are restored. But *do* be sure to mark your calendar – maybe around December 1st – to take your RMD before year-end, one way or another. Failing to do so can trigger a severe tax penalty. ■

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dubbed the "fragile five." Nations are often late in making needed policy adjustments, but emerging countries' underlying fundamentals and flexible markets can quicken their response to such changes. The fragile five have made monetary and fiscal adjustments that should be constructive regardless of Fed policy. Better growth prospects and an easing of imbalances appear to be taking hold.

Now the prospect of political instability could constrict the flow of global capital into some countries' financial markets and direct investment opportunities. Venezuela and Argentina appear to have pursued destructive policies masked for a time by the major commodities boom of the 2000's. And Russia's own treatment of outside investors has been mixed at best.

Twenty-five years ago the MSCI Emerging Markets Index represented just 10 countries and 1% of global equity market capitalization. Today it covers 800 securities across 21 markets and about 11% of global market cap. Recent underperformance is simply another reminder that volatility is part of the price for some of the world's more intriguing growth opportunities. ■

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