KMS
Client Quarterly
Summer 2014

Compliments of

Your Investment Professional

Published June, 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

Investors Debate the State of China's Great Transition

Staying abreast of developments in China has been a recurring theme in these pages for more than 20 years. Recent media coverage has focused on some easing of China's growth rate, a decline in exports, expansion of debt, and the relative opacity of financial dealings. It's important to set these issues in context.

China's transformation has been remarkable. From a deeply underdeveloped status 35 years ago, China's current gross domestic product (GDP) per person has reached the level of 1950s America. Average life expectancy has risen from 66 to 76, and state control of the economy is estimated to have dropped from 70% to 42%. Specialists at Matthews Asia Funds see China as "a robust system of private enterprise, intermediated by a dysfunctional state-owned financial system."

Much nervousness about China stems from the sense that credit and capital allocation are still dominated by state-owned banks and various levels of the ruling party. This fosters inefficiency and corruption, but it also gives the central authority leverage to attenuate credit and temper excesses. Even upper-range estimates of this debt as a share of GDP compare favorably to U.S. government-issued debt. And the obligations are largely internal, backed by the government's prodigious resources, including $3.5 trillion in foreign currency reserves.

Concerns are also raised about China's shadow banking system, a sinister sounding term that simply refers to private lending arrangements. Such lending is largely disciplined by relatively high interest rates and levels of collateral. Those who favor capital allocation by private decision makers should favor *more* shadow banking, given China's underdeveloped capital markets.

The extremes of opinion on China's prospects are not unlike the constant debate over our own economy and culture. But the overarching story is one of remarkable transition alongside daunting challenges. There is probably no parallel in history for such a huge and rapid transition of people from relatively primitive rural life to the trappings of 21st century, urban, middle class prosperity. Our own seemingly rapid industrialization spanned more than

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Retirement Crisis? Maybe, or Maybe Not

Whenever the press and financial services industry unite around a story line, it's probably worth a second look. The idea that America is headed for a retirement crisis is one of those mantras, but in a recent study, analysts with retirement plan consultant Towers Watson reached a somewhat rosier conclusion.

The study, titled "American Workers' Retirement Income Security Prospects: A Critique of Recent Assessments," notes that "some assessments of what workers should save and when they should save it dramatically understate the adequacy of retirement savings for many households." Most notably, it recognizes that progress in saving for retirement usually is *not* linear.

Spending demands relative to income tend to be greater in the years spent establishing a home, raising children, etc. The kids' college costs often force a temporary pause in the process of retirement savings. The Towers Watson study suggests that a couple with two children is carrying expenses comparable to 2.64 adults living separately, while a childless couple is covering the equivalent of just 1.63 solo adults.

But as mortgage payments and college costs fall away, the retirement income to sustain one's lifestyle may be more achievable than it would have appeared during the child-rearing years. Of course whatever one can save early in a career can make a big difference. Taking advantage of an employer's 401(k) match and other tax-deferred savings opportunities can build assets positioned for investment returns during those middle years when the ability to make new contributions may be strained.

The study suggests that overly pessimistic or daunting assessments can actually discourage rather than stimulate efforts to save. Morningstar's Vice President for Research, John Rekenthaler, reinforces that concern. He notes that in early testing of Morningstar's online retirement-advice software, "almost half the users quit the program after seeing their 'gap' page – the difference between the retirement income they sought and the retirement income they were on track to receive." Morningstar tweaked the program to deliver the mathematical reality a little less discouragingly, but it still presented a psychological hurdle.

Several studies have promoted a retirement income target of 85% of one's preretirement, pretax income. With some moderation of expenses and effective tax and Social Security planning, a little lower replacement ratio might suffice. On the other hand, there's comfort in creating a meaningful margin for error, and that still argues for saving as early and often as you can. ■

Nervous About Stock and Bond Markets? There Are "Alternatives."

Some years ago – 11 to be exact – the *Quarterly* reviewed the emergence of mutual funds employing the kind of portfolio strategies traditionally associated with private hedge funds that cater to very wealthy individual investors and institutions. In the ensuing years this "alternatives" sector of the fund universe has expanded dramatically. Fund researcher Morningstar now follows 1,400 such funds and ETF covering ever greater variety of assets and strategies.

Assets invested in the alt-fund category hit $132 billion at the end of 2013, capturing $40 billion of inflows for the year – more than was directed into all types of domestic taxable bonds combined. One might question the timing, at least so far, but there is some logic to that heightened interest. It's hard to see a lot of opportunity in ultra-low yielding traditional fixed-income vehicles. And the big move for stocks in recent years has investors wondering when a correction or even a bear market might be in the offing.

Many alternative strategies explicitly seek *not* to parallel broad market trends, an especially saleable attribute after the gut-wrenching sell-off in major markets six years ago. But that creates its own challenges. For many alternative strategies, non-correlation with mainstream markets has meant lackluster performance in recent years.

Morningstar tracks 13 alt-fund categories, but about 90% of invested assets are in funds deploying strategies characterized as long/short equity, multi-alternative, market neutral, multi-currency, or managed futures. A number of funds oversee allocations across managers representing some or all of those styles.

As noted above, the years since the financial crisis have been relatively trying in hedge fund land. The HFRX Global Hedge Fund Index shows a *cumulative* return of just 14.7% for the five years ended May 31, 2014, compared to a cumulative 132.6% for the Standard & Poor's 500 Index over that time frame. But diversification is the point. Strategies that seek returns in ways that differ markedly from traditional stock and bond funds might be *expected* to lag when the rest of your portfolio is doing well.

Evaluating and selecting alternative funds is not so different from reviewing traditional stock and bond offerings. You might ask:

• Do I have a basic understanding of the strategy and the rationale for its effectiveness over time?

• How substantial is the manager's organization, and how long is their track record with this strategy?

• How might the strategy complement my portfolio, diversify its sources of potential return, and temper its volatility?

Investors have had a tendency to gloss over such issues when slightly esoteric investments are introduced. There's no reason to repeat that mistake with alternatives. ■

Tuning In to the Economic Cycle

Trying to time investments is notoriously tough, but financial markets do tend to respond to the economic cycle. A sense of where that cycle stands can be helpful in gauging relative risk.

Pronouncements from the Federal Reserve get lots of media attention, perhaps because it's an easy beat for financial reporters. But the Fed is not known as a great prognosticator, having largely missed a whole series of notable turning points in recent decades. Other organs of government, Wall Street, or the media haven't done much better, so where can one turn?

Traditional economics textbooks suggest that in a business expansion manufacturers get overly enthusiastic and produce more than they can sell. Then they have to reduce shifts, maybe even close factories, and lay off workers. That sounds about right, if we're talking about the 1950s, but isn't the structure of today's economy quite different?

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Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized thru June 9, 2014 ---**			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Core)	20.1 %	15.7 %	16.7 %	7.4 %
Mid-cap Stocks (Core)	21.3	14.6	18.3	9.1
Small-cap Stocks (Core) †	21.2	15.1	18.7	9.1
Foreign Stocks (Multi-cap) †	17.5	7.6	11.4	6.9
Emerging Markets †	8.2	0.1	8.8	11.2
Natural Resources	23.4	7.5	12.6	12.1
Real Estate Related	10.3	11.3	21.0	9.2
Flexible Portfolio	9.2	6.5	10.9	6.6
General Bond	3.5	5.5	7.5	6.3
Int'l Fixed Income †	3.7	2.1	5.5	5.5
High-Yield Taxable Bond †	8.2	8.0	12.6	7.7
General Municipal Debt	2.4	5.6	6.1	4.3

* Source: Lipper, as reported in the online *Wall Street Journal*, June 10, 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.

Roth IRAs Are Increasingly Popular, Especially with Younger Investors

Analysis released last year by the Internal Revenue Service shows younger investors are choosing Roth IRAs over the traditional variety in large numbers. Fund manager T. Rowe Price confirms that as of year-end 2013, investors under 34 have eight times as much money in Roth IRAs as in traditional IRAs. The younger the investor the greater the lean toward the Roth.

There's logic to that, assuming young investors are looking at currently low marginal tax rates, lots of years to enjoy tax-deferred growth, and easier access to a portion of their Roth assets if a need arises a few years down the road. But as those same workers edge into higher marginal tax brackets the argument gets a little more nuanced.

The main lure of the Roth IRA is the promise of tax-free income in retirement. But is a young worker's biggest worry the tax burden she'll carry in retirement? Or is it the challenge of saving enough to support a comfortable retirement?

There are always plenty of competing demands for the dollars we might otherwise set aside for the future. One's tax rate in retirement, 30-35 years down the road, can be a tenuous rationale for forgoing the deduction one might capture with a traditional IRA contribution today. After all, that deduction lowers the out-of-pocket cost of the IRA contribution which facilitates *more* savings. And that's a certainty now rather than a possibility in the distant future.

Even if a young investor has the funds to maximize an IRA contribution – Roth *or* traditional – there are other tax-deferred vehicles in which to invest the tax savings from a traditional IRA contribution. And that brings us to one of the most basic financial planning precepts: Try to control as much capital as you can for as long as you can. Paying income taxes at a high rate in one's golden years generally indicates that it all worked out reasonably well.

Nevertheless, popularity of the Roth IRA is widespread. According to the Employee Benefit Research Institute, Roth balances grew twice as fast as traditional IRA balances between 2010 and 2012. It looks like a lot of people would just as soon pay taxes today for the promise of avoiding them someday. ■

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Tuning In ...

Economist John Maynard Keynes offered the broader characterization of an excess of "animal spirits" – a collective rise in business and consumer confidence boosting consumer demand and bidding up prices until the Fed dampens those spirits with higher interest rates. However, there was no surge of general U.S. inflation to presage the 2008-09 global financial crisis.

Tad Rivelle, Chief Investment Officer for fixed income at TCW in Los Angeles, sees the U.S. economic cycle as highly correlated with the cost and availability of credit. Disruption or decline in credit markets tends to prompt deleveraging and economic slowing. The economy may be buttressed by enterprises that are well established and highly liquid, but at the margin, investors and entrepreneurs curtail their borrowing and spending.

If asset prices are being propped up at artificially high prices, reality is bound to assert itself at some point. A classic late-stage indicator is a rise in volatility as market players become more sensitive to the possibility that valuations are stretched. Seemingly minor events can produce exaggerated market effects such as the unsettling reaction a year ago when the Fed announced near-term plans to start "tapering" its bond purchases.

There's no sure signal that an economic or market cycle is turning. The odds of a turn, or at least a meaningful correction, rise as bull markets and economic expansions age. That risk reinforces the value of high quality fixed-income holdings and stocks of companies with strong operating margins. One might enjoy most of the party and still be able to drive safely home. ■

A Rarely Discussed Risk for Retirees

Don't tell Warren Buffett, but many scientists who focus on the human brain believe that as we age, many of us will see a falloff in our ability to manage financial matters.

Dr. Joe Verghese, neurologist at Albert Einstein College of Medicine and chief of geriatrics at Einstein and Montefiore Medical Center in New York, notes that many cognitive functions or processes involved in financial decision making are located in the frontal cortex. This part of the brain is predominant through most of our adult years, so our investing acumen tends to improve at least into our mid-50s.

After that the brain's limbic system, the seat of primal emotions like fear and greed, tends to gain sway. These are just tendencies, and few investors of *any* age are immune to the fear-greed cycle. Nevertheless, there are precautions we might consider as we age, such as:

- Opting for simpler, more systematic investment strategies and consolidated accounts, if possible;
- Auto-deposit of Social Security benefits and other distributions to a central account that another trusted individual can access and monitor;
- Arranging for key payments (mortgage, utilities, taxes, long-term care insurance) to be maintained;
- Introducing your financial and tax advisor to one or more trusted family members.

Over a lifetime of investing we face a wide range of risks. Their timing may be hard to predict, but that doesn't mean we can't prepare for their eventuality. ■

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... the State of China's Great Transition

a century and featured all manner of social and economic dislocation, environmental degradation, and political wrangling.

Still there's the question of exactly how an authoritarian political structure can both promote *and* contain the aspirations and expectations of a citizenry on the crest of that wave. The recent 25th anniversary of the Tiananmen Square crackdown pointed up the Party's efforts to control information flow across an increasingly tech-savvy population. According to Nielsen, China today boasts over 600 million Internet users, 465 million of whom actively employ mobile applications.

Global investors can see a dynamic symbol of that emergence with the initial public stock offering for Alibaba, China's giant online commerce site. And one of Alibaba's hot new business ventures is Yu'e Bao, an online money market fund. It was only a few decades ago that the advent of money market funds shook up our own rather sleepy consumer banking sector.

Meanwhile, China's governing Central Committee recently held its Third Plenary Session, outlining *official* initiatives to liberalize interest rates, establish a market for bond futures, and form a Shanghai-based Pilot Free Trade Zone to promote freer financial services. The parade marches on, despite some ambiguity as to who is leading whom. ■

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Pot's Decriminalization Prompts Investor Alerts

With the states of Washington and Colorado having recently legalized recreational use of marijuana and legitimized its controlled sale, there's a *whiff* of new business opportunity in the air. It looks like securities regulators smell something too. They're warning investors to be wary of weed-based investment offerings, especially those promising inordinately *high* returns.

In an apparent *joint* effort, both the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have urged investors not to get *sucked* in by the *buzz*. As FINRA noted recently, "the cannabis business has been getting a lot of attention – including the attention of scammers."

So if your laptop and smart phone are suddenly *lighting* up with pitches to invest in this *budding* new industry, be careful. Some of those ventures may carry the *seeds* of legitimacy, but keep your wits about you and make sure you're getting the straight *dope*. Otherwise, your *stash* could take an unfortunate *hit*. ■

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