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Peggy Farnworth, CFP®, CPA, CSA

2404 Bank Drive Suite 210

Boise, ID 83705

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Greece Makes Its Pitch for Better Terms...

Exactly five years ago we covered the revelation of Greece's blowout debt problem. Given the depth of that sink hole and some hard political realities, it's not surprising that this continental confrontation is making headlines again.

Greece's recent election brought Alexis Tsipras's left-leaning Syriza party to power on a pledge to repudiate the "austerity" measures Greece had agreed to as part of an EU/IMF bailout. A block of European Union members led by Germany seek confirmation that Athens will honor those conditions.

The parties stepped back from the brink on February 20th as Greece signed a four-month extension of its austerity commitments after less than a month of talks. This preserved its access to €14.9 billion of near-term liquidity.

Greece will continue to seek modification of those reforms and budget constraints. Germany's Angela Merkel must show her electorate that Greece will be held accountable. Spain, Portugal, and Italy are watching, each with its own political factions resistant to similar demands for reform and budget discipline.

The larger euro zone nations may not have much to gain from expelling Greece. Germany is owed €50 billion of that prior bailout, but its leaders have conveyed the message that while it prefers to see Greece stay with the euro, its exit would be manageable.

Even as Greek voters cheer their new government, many have been hedging their bets by pulling money from local banks to hold cash in euros. That reflects fear that a sudden conversion to the drachma could slash the buying power of Greek bank balances. Those withdrawals serve to reduce capital available for consumer and business lending.

Five years ago we noted that "*someone* ultimately pays for unfettered deficit spending." Spreading the payment out indefinitely appears to have exacted a price in terms of the euro zone's economic performance. And a stronger economy is the positive path forward. ■

... As Europe Draws Investor Interest

If the situation with Greece is such a dilemma for the European Union, why are the region's stocks off to such a brisk start in 2015? That's right, the average mutual fund focusing on EU-based equities is ahead several percentage points in U.S. dollar terms, despite a roughly 10% drop in the euro this year. In their local coin, European stocks have surged by double digits.

Currency is certainly one factor. The euro is down nearly 25% against the dollar over the past 10 months. That's a very big move for a major global currency, now at its lowest level in more than a decade. That appears to largely reflect investor disappointment with the continent's domestic economic performance, but many of Europe's leading companies are major exporters. A markedly cheaper euro creates a meaningful pricing advantage for those companies selling goods abroad, especially to U.S. consumers and businesses.

It's hard to guess where or when the euro might stabilize or rebound.

continued on page 3 ►

The Long Road Back for Nasdaq

This *Quarterly* coincides with the 15th anniversary of the peak of one of history's great investment bubbles. March 10, 2000, the Nasdaq Composite Index closed at an all-time high of 5048.62. Information technology and telecommunications services then represented 70% of Nasdaq's market capitalization, including many of the brightest stars in the new internet firmament.

In retrospect it's hard to fault that enthusiasm for the emerging digital revolution. But its translation into stock prices certainly got ahead of itself. The bursting of the bubble was swift and painful for the most "invested" believers. The Nasdaq shed nearly 2000 points in two months and *another* 2000 by the bear market low on October 9, 2002. Many who lived the experience wondered if they'd ever again see the index above 5000.

Yet, rather quietly and seemingly on cue, Nasdaq did scramble atop that wall on March 2nd. Tech has led the way as it still represents over 40% of Nasdaq's market capitalization. Telecom is now a much smaller component, while healthcare and consumer discretionary now combine for about 38% of the index.

Nasdaq remains a listing place for many companies with dynamic growth potential. Six years into the current bull market U.S. stocks may not be deemed cheap. Nasdaq's 2,569 issues collectively sell at nearly 32 times earnings, but its 10 largest names average a more grounded P/E of 21. That's a far cry from that fleeting moment 15 years ago when Nasdaq's implied multiple was *190 times* prior year earnings, surely one of the history's great fits of untethered "new era" thinking. ■

On Guard for the Fragile Decade

Some call it the "fragile decade," that first 10 years of retirement when market movements can have a profound effect on a portfolio's ability to sustain income and financial security for the years ahead. It has a lot to do with the sequencing of returns.

In the years leading up to retirement, many investors have discretionary income to make meaningful contributions to retirement savings, and they're not yet drawing from those nest eggs. If markets are down, they're buying in at lower prices with better upside prospects ahead. But once that employment income must be replaced, at least in part, by withdrawals from retirement savings, the impact of a significant market downturn can be magnified.

Suppose one starts retirement with a diversified, million-dollar portfolio and initiates 4% annual withdrawals. If in the first year of retirement the portfolio suffers a 10% market-driven decline, and then a 5% decline in year two, those withdrawals will trim that $1,000,000 portfolio down to about $780,000.

At that level, $40,000 represents a more aggressive 5.1% withdrawal rate. Even a 15% bounce-back performance for the underlying investment holdings in year three will only restore the portfolio to about $850,000 net of those ongoing withdrawals.

The foregoing is hardly a disaster scenario. Yet the odds of a diversified portfolio supporting that $40,000 annual withdrawal have dropped a few percentage points, as indicated in the accompanying table. If the decline is severe enough to make that $40,000 a *6%* distribution rate, the 30-year sustainability odds drop all the way to 69%.

Fortunately there are strategies to guard against an unlucky sequence of returns in the fragile decade. That's a discussion to be had and regularly revisited with your investment professional. ■

Sustainability of Income

For a Portfolio Diversified as Follows:	At a withdrawal rates of: 3%	4%	5%	6%
24% U.S. Stocks 24% Internat'l Stocks 24% U.S. Bonds 20% Global Bonds 5% Cash	**Chances of sustaining income for 30+ years is...** 95%	95%	92%	69%

Asset class indexes: Cash: 90-Day U.S. Treasury; U.S. Stocks: S&P 500 Index; U.S. Bonds: Ibboston U.S. Long-Term Corp. Bond Index; Internat'l Stocks: MSCI EAFE Index2; Global Bonds: Citigroup World Government Bond Index
Source: Franklin Templeton Investments

Pensions Have It Easier than People

The preceding article presents some numbers distilled from studies on the sustainability of different withdrawal rates from a diversified investment portfolio. Pegging such a number is a simple approach to setting retirement income and spending levels – maybe a little too simple according to the Russell Company, a major consultant to pension funds, endowments, and other institutional investors.

Russell's latest Financial Professional Outlook survey suggests that setting reasonable retirement spending expectations is a critical challenge. Russell suggests taking a page from traditional pension fund accounting by calculating your own *funded ratio*. That ratio is determined by dividing the net present value of one's investment assets by expected lifetime liabilities.

That's valuable perspective and perhaps another helpful data point. But real-life retirees will note some problems, starting with the numerator. Net present value of assets may be fairly easy to determine, but when those values take a hit in a market downturn, large pension funds can look to an operating company or a taxing authority for additional funding to help restore the pension fund's coverage ratio. Individual retirees usually don't have that luxury, short of going back to work.

continued on page 4 ►

Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	--- Annualized thru March 6, 2015 ---			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Core)	10.4 %	16.7 %	13.6%	7.0 %
Mid-cap Stocks (Core)	7.0	16.6	13.9	8.1
Small-cap Stocks (Core) †	2.2	15.4	13.3	7.6
Foreign Stocks (Multi-cap) †	− 1.9	9.4	6.5	4.4
Emerging Markets †	− 0.2	0.8	2.0	6.9
Natural Resources	−18.0	− 0.5	2.9	4.3
Real Estate Related	16.7	13.0	15.1	7.7
Flexible Portfolio	2.1	7.6	7.9	5.6
General Bond	4.5	4.6	6.9	5.9
Int'l Fixed Income †	− 3.1	0.3	2.4	3.9
High-Yield Taxable Bond †	0.9	6.6	7.9	6.5
General Municipal Debt	6.6	3.9	5.0	4.0

* Source: Lipper, as reported in the online *Wall Street Journal*, March 7, 2015.
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.

Where *Does* the Money Go? A Look at Fractional Reserve Banking

Ah, money. Does it *really* make the world go 'round? And if so, *how*? Such questions tend to find their way back to the Federal Reserve operating under its dual mandate to maintain an environment of stable prices *and* full employment. Parsing those benchmarks is a topic for another time. We want to look at the structural backdrop through which the Fed has been trying to meet those goals: the fractional reserve banking system.

Fractional reserve banking exists to promote and regulate the flow of liquidity to the economy. U.S. banks are required to keep a fraction of their deposits, currently 10%, in reserve. They can lend out or directly invest the balance (excess reserves). When they lend or invest, some of those funds become deposits in other banks that also operate under a reserve requirement and can lend or invest the rest. Those investments promulgate deposits in other banking institutions, and so it goes.

The accompanying table shows how one dollar of truly new deposits to the banking system can be leveraged into as much as nine dollars in added liquidity to fund economic activity. Over the course of 2013, the Federal Reserve bought $759 billion in U.S. Treasuries. Injecting that into the banking system could potentially expand the money supply by nearly seven trillion dollars. That assumes healthy demand from borrowers and/or investment opportunities that bank managers view as both prudent and attractive.

The Fractional Reserve System
Leveraging $10,000 of "New" Deposits

Deposited with ...	Required Reserve*	Excess Reserves	Cum. Loans / Investments
Bank #1	$ 1,000	$ 9,000	$ 9,000
Bank #2	$ 900	$ 8,100	$ 17,100
Bank #3	$ 810	$ 7,290	$ 24,390
Bank #4	$ 729	$ 6,561	$ 30,951
Bank #5	$ 656	$ 5,905	$ 36,856
Bank #6	$ 590	$ 5,314	$ 42,170
Bank #7	$ 531	$ 4,783	$ 46,953
Bank #8	$ 478	$ 4,305	$ 51,258
Bank #9	$ 430	$ 3,874	$ 55,132
Bank #10	$ 387	$ 1,216	$ 58,619
Bank #20	$ 135	$ 1,216	$ 79,058
Final	**$ 0**	**$ 0**	**$ 90,000**

*Assumes 10% reserve requirement, leaving 90% of each deposit as "excess reserves" available for the bank institution to lend or invest.

In the financial crisis the Fed cut interest rates and reduced reserve requirements to spur lending. And since 2008 the Fed has paid banks interest on required and excess reserves. Historically, the notable risk of such actions has been inflation – the potential to create too much money chasing too few goods and services. Although recent inflation has been very modest, at least by such standard measures as the Consumer Price Index or the Purchasing Managers' Index, there are other areas of potential inflation.

In the absence of attractive lending or investment opportunities, banks may just park those deposits in the most liquid, high quality securities with some narrow yield advantage over the cost of the deposits, including U.S Treasuries with slightly longer maturities, government agency obligations, and the highest quality corporate debt. These are the very assets that have soared to record high prices (i.e., record low yields) in recent years. Other large market participants have scooped up the most liquid stocks, helping spur a great run for blue chips.

Some analysts see this as a store of excess liquidity that could spur a surge in prices for goods and services if the pace of economic expansion really picks up. And a resulting rise in interest rates could offer stiffer competition for stocks. Money always chases something, and the direction of those flows can turn without a lot of notice. ■

► *cont'd from page 1 / ...* *Europe Investor Interest*

The European Central Bank (ECB) just launched its widely anticipated program of quantitative easing. That strategy is designed to push extra money into the economy and lower interest rates to promote lending while boosting asset prices and inflation expectations – hardly a formula for a stronger euro.

Meanwhile, U.S. economic numbers continue to point toward a tightening by the Federal Reserve which ended its own quantitative easing last year. So it appears the euro-dollar exchange rate will continue to assist Europe's exporters.

Over the past 35 years, investors have tended to discount European companies an average of 10% by standard valuation metrics versus their U.S. counterparts. According to Ned Davis Research that discount has deepened since the financial crisis and recently hit a historic extreme of more than 40%. Some discount may continue to make sense given the U.S.'s faster growth, labor flexibility, and culture of innovation. But Europe's established global competitors are getting a fresh look from value investors.

The biggest question mark remains the political challenge of effecting real reform of labor markets, entitlements, entrenched bureaucracy and regulation. There has been some progress. Over the past five years Greece's cost of labor per unit of output has fallen by more than 12%. Spain, Portugal, and Ireland also have improved notably on this front, and Germany's labor productivity is world class.

Whether Europe's broad domestic economy can get on a faster growth track is a complex question. But investors may well separate that consideration from their view of European companies that perform effectively on a global stage. ■

Go ahead and pat yourself on the back. You probably deserve it.

It may not be a big surprise that most millionaires cite prudent spending and saving, plus hard work, as the prime drivers of their financial achievement. We're all inclined to view our successes as the result of virtuous, intelligent behavior. It's part of the reward.

In a recent survey conducted by PNC Financial Services Group, 65% of respondents cited hard work as the key contributing factor, while 56% gave a nod to having saved regularly and from an early age.

Tied at a 38% response rate were the importance of controlling spending and making good investment decisions. Controlling spending is an obvious prerequisite to being able to save early and consistently. And good investment decisions don't matter much unless they apply to a meaningful pool of capital.

Only about 26% of respondents cited relatively high earnings as a key factor. Even fewer, 12%, pointed to inheritance, while 3% said they married into money. Luck sometimes plays a central role, but that's pretty hard to predict or control. Among these millionaire's current concerns, having sufficient assets to live comfortably and cover healthcare expenses through retirement was number one. Preserving capital was cited more than twice as frequently as accumulating more. A worthy reminder looking back at a six-year bull market. ■

Peggy Farnworth, CFP®, CPA, CSA
2404 Bank Drive Suite 210
Boise, ID 83705

► ***continued from page 2*** / *Pensions Have It Easier ...*

Then there's the denominator: expected lifetime liabilities. Pension administrators only have to factor in the scope of their plan's obligation to retirees and the average life expectancy of that cohort. That's why it's called a "defined benefit" plan. For any individual or couple, lifetime liabilities can encompass not only the upward creep in the cost of living, but *all* the vagaries of life such as the onset of major health issues, needs of other family members, etc. It's not so much the *expected* liabilities that keep us up at night.

We all recognize that our own life experiences and investment results can turn out to be quite different from the long-term, smoothed averages that actuaries use to gauge the adequacy of pension plan funding. That reinforces the need for a little bigger margin of error, a periodic review of how one's retirement income and spending strategy is holding up, and the flexibility to adjust to changing circumstances. Coverage ratios and historic probabilities can provide some useful context, but probably *not* a guaranteed number to just set and forget. ■

For information on our services, please contact:
Peggy Farnworth, CFP®, CPA, CSA
208-343-7777

peggy.farnworth@kmsfinancial.com