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Markets Await Decision by U.K. Voters on "Brexit"

At this writing, citizens of the United Kingdom (U.K.) are mulling over their June 23rd vote on continuing as part of the European Union (EU) or exiting that integral association. The EU is one of the largest economic unions in history. It joins 28 member nations in a landmark effort to facilitate freer cross-border movement of people as well as goods and services, and by implication, boost business' confidence to hire, invest, and expand.

Nevertheless, recent polls indicate that the referendum question remains a pretty close call. So, what are the key issues, and what would "Brexit" mean to the U.K. and to financial markets?

Key issues cited by those who favor leaving the EU ("Brexit") revolve around sovereignty, trade, the costs of EU member obligations, the slow pace of integrating the market in services, and the hot button of unrestrained immigration. Brexit proponents contend that EU membership has negative implications for trade with nations that are not part of the EU. They see many of its regulations as impinging on the U.K. economy's competitiveness.

Specifically on immigration, the Single European Labor Market allows free cross-border movement of the 28 EU members' citizens. The Brexit side tends to believe that the inflow of immigrants, attracted by the U.K.'s stronger economy, has taxed the nation's public resources.

Counters to those arguments include the fact that the rest of the EU is actually the U.K.'s main export market accounting for 45% of its exports. It is clear that other world class competitors such as Germany

continued on page 3 ►

Cycling Through Capital Gains Taxes

If you found the recent tax season to be a bit more punishing, you weren't alone. Affluent investors have experienced a double whammy: higher tax rates on capital gains coupled with more gains being distributed by equity mutual funds.

Each year funds are required to distribute nearly all of their net investment income – dividends and net realized gains – which are taxable to shareholders unless the shares are held in tax-exempt or tax-deferred accounts. Morningstar reports that two-thirds of all equity funds paid out capital gains last year – twice the number from just four years earlier. Fund managers, aware that many of their shareholders are in tax-deferred accounts, generally do not focus on minimizing net gains. Also, in the 2008-09 financial crisis, many equity funds accumulated capital losses that helped reduce net gain distributions in the first few years of the post-crisis rally.

By last year, those losses were largely exhausted, and many fund portfolios were carrying substantial embedded gains. As shown below, this cycle of gain distributions has been pronounced in recent decades, responding to the cyclical performance of stocks. A run of positive years leads to gain realizations on a delayed basis, often as the market gives ground (as in mid-2015), and fund managers reallocate portfolios.

The other part of the equation, capital gains tax *rates*, changed materially with passage of the Taxpayer Relief Act of 2012. Many upper-income households saw their rate on capital gains go from 15% to 23.8%, the biggest jump in nearly 30 years.

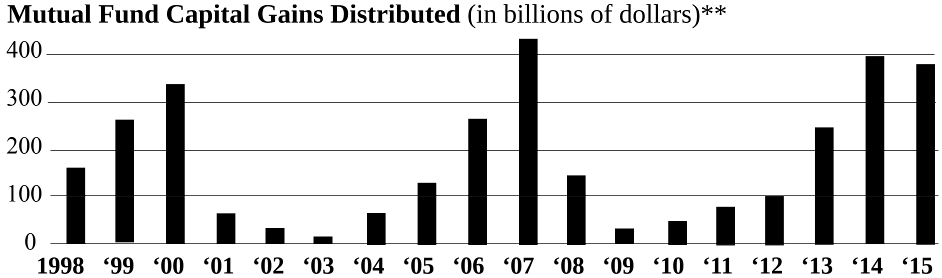
Higher gain realizations and higher tax rates may influence *where* one elects to hold equity funds plus other strategies to mitigate the tax impact. Your financial and tax advisors can help evaluate the issue within the context of your personal tax situation and investment objectives. ■

The Cycle of Market Returns and Capital Gain Distributions

S&P 500 Year-by-Year % Returns (rounded to nearest whole percentage point)*

+29 +21 −9 −12 −22 +29 +11 +5 +16 +5 −37 +26 +15 +2 +16 +32 +14 +1%

Mutual Fund Capital Gains Distributed (in billions of dollars)**



Sources: *Morningstar **Investment Company Institute

Real Estate Gets Its Own Slice of the Index

Every few years we try to visit the world of real estate investment trusts (REITs) which offer convenient, liquid access to diversified portfolios of professionally managed real property.

REIT shares have been relative winners in recent years, as reflected in the accompanying table. They delivered an especially welcome contrast to mainstream equity returns over the past 12 months.

But they also can deliver their fair share of volatility. In the financial crisis, the market value of real estate companies in the Standard & Poor's 500 Index dropped from almost $200 billion at the 2007 peak to about $65 billion at 2009's trough. Their subsequent rise has been dramatic to more than $500 billion of market cap today.

REITs and other real estate companies are currently lumped in with the Financials sector of the S&P 500. They account for about 20% of that sector, which itself represents about 16% of the Index. But later this summer, Real Estate will become the first *new* sector in the S&P 500 since the Global Industry Classification Standard (GICS) was introduced in 1999.

The new Real Estate sector is expected to weigh in at about 3% of the S&P, in the same range as the weightings for Utilities, Telecom, and Materials. Some analysts expect to see increased REIT buying from portfolio and fund managers who track the S&P 500 or at least use its weightings as a starting point.

A specific slice for real estate in the S&P may give a temporary boost at the margin, but other factors such as the course of interest rates and the broad economy are sure to be more influential. Longer term, the case for REITs hasn't really changed:

• **Attractive dividends** fed by the requirement for REITs to distribute at least 90% of taxable income;

• **Liquid exposure** to geographically diverse commercial, residential, industrial properties, with relatively low correlation to the broad equity market;

• **Inflation responsive** underlying assets as rents and property prices have historically reflected, and in some cases outpaced, increases in the Consumer Price Index. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through June 3, 2016 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	− 2.0 %	8.9 %	10.5 %	6.3 %
Mid-cap Stocks (Blend)	− 5.5	7.5	8.9	6.4
Small-cap Stocks (Blend) †	− 8.8	6.9	8.1	6.4
Foreign Stocks (Large Blend) †	− 7.8	3.0	3.0	2.9
Diversified Emerging Markets †	− 13.4	− 4.1	− 3.7	2.7
Specialty Natural Resources †	− 14.3	− 5.6	− 4.8	− 0.5
Specialty Real Estate †	9.9	9.3	10.0	6.1
Cons. Allocation (30-50% Equity)	− 0.9	3.4	4.6	4.4
Long-term Bond	10.8	5.6	7.0	7.4
World Bond †	2.9	0.8	1.6	4.2
High-Yield Taxable Bond †	− 2.2	2.0	4.3	5.9
Long-term Municipal Bond	6.6	3.9	5.4	4.4

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-sepecific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

Japan's Economic Struggles Obscure Companies' Success

Time flies, events fade, and five years have slipped by since Japan's catastrophic tsunami and the resulting meltdown at the Fukushima nuclear plant. As we noted then, the scenes of devastation seemed a cruel coda to two decades of serial economic disappointments and a dismal stock market. But we also noted a few intriguing bullet points for contrarian investors, such as:

• Since 2000, Japan's listed companies had shown *better per-share earnings growth* than their European and U.S. counterparts.

• *Productivity gains* had been especially noteworthy.

• *Thirty percent of sales were coming from overseas* with exports to China up ten-fold in ten years.

• Japanese stocks were trading at *lower multiples than comparable global competitors* for the first time in 30 years.

The challenge of getting Japan's domestic economy in gear still gets most of the attention. But along the way, mutual funds focused on Japanese *stocks* turned in a very respectable 7% average annualized return for the past five years. That's a marked contrast to the *negative* returns for diversified emerging markets funds over the same period, despite broadening prosperity across much of *emerging* Asia.

To a significant extent, this is a story of Japan's protracted domestic deflation plus its proximity as a key exporter of quality products into a rising tide of middle class consumers. Asia is projected to represent a middle class of more than 1.7 billion people by 2020, much larger than North America and Europe combined. By 2030, they may wield twice the spending power of the combined North American and European middle class.

For Japanese companies, the key factor has been emerging Asian consumers' rapidly growing ability

continued on page 4 ►

Being Part of the "Gig" Economy Presents Planning Challenges

Are you among the rapidly growing ranks of U.S. workers moving into freelance, independent, and on-demand employment? If so, you may have some added decisions and opportunities to consider on the financial planning front.

According to one recent study, about a third of America's workforce receive income from freelancing or self-employment. That compares to only about 6% of workers two decades ago. Those ranks include independent contractors, individual business owners, moonlighters, and temporary workers.

According to the Bureau of Labor Statistics, the 18-34 year-old cohort represents about two thirds of the "sharing" workforce. But older, more experienced professionals are also actively pursued by on-demand employers for their backlog of experience and established work habits.

Financial advisors are recognizing areas of special interest and guidance for those in the gig economy, including these basics:

• Consider setting up **separate bank accounts** for your gig-related income and expenditures.

• Check out financial management software such as Mint or Quicken to track the financial side of your self-employed endeavors and to be better organized to realize the business-related tax deductions to which you are entitled.

• Enlist your tax and investment professionals to help you navigate flexible alternatives for **tax-advantaged retirement savings**, health savings accounts, etc.

• Remember the obligation to make **estimated quarterly tax payments** if you have a significant amount of income that is *not* subject to employer withholding.

• Look into **career coaching and recruitment services** to help fill your pipeline of future engagements. Online job matching and other services include Work Market, Guru and Upwork.

• **Task- and time-management tools** such as Evernote, Google Apps, and DeskTime may help.

The term *gig economy* may have a casual connotation, but it's about your livelihood and your future. ■

► *cont'd from page 1…* *Decision on "Brexit"*

and Sweden also have seen their respective trade balances improve over the course of 30 years as members of the EU.

Post-exit, the U.K. would almost certainly need to negotiate comparable terms of trade through bi-lateral agreements with key EU members. As for trade deals with the *rest* of the world, it's not clear that the U.K. could be expected to fare better on its own than as part of the EU block of 445 million consumers.

As for the immigration argument, economists at BCA Research calculate that immigrants from other EU countries have contributed 47% of the U.K.'s labor force growth since 2010. And the U.K.'s native-born workers are actually much more likely to claim public benefits than are those immigrants from other EU nations.

Markets dislike uncertainty, so investors might expect a relief rally if the Brits vote to "Bremain" in the EU. If the referendum favors "Brexit," a reflexive selloff in the FTSE 100 stock index may ensue. But the FTSE is a global index heavily influenced by prospects for the energy, metals, and mining sectors. The FTSE 250 actually has more substantial exposure to the domestic U.K. economy, which would be the focus of Brexit-related concerns.

Under *either* outcome, the effects will be multi-faceted, ambiguous, and spread over time. And soon enough, those Brexit headlines in the financial news will be replaced by other preoccupations. ■

Good News *and* Bad for Corporate Plans

These pages occasionally drop in on developments with corporate pension plans. In the wake of the 2008 financial crisis, several years of stronger investment returns helped restore healthier funding status, but the challenge has re-emerged over the past year.

BNY Mellon reports that, as of April, corporate defined benefit pension plans had slipped just below 80% of being fully funded for their future obligations based on actuarial and rate-of-return assumptions. That's down from nearly 85% as recently as last October.

According to BNY Mellon, the companies that comprise the Standard & Poor's 500 saw their collective pension funding shortfall grow by $13 billion in April alone, to $436 billion. Assets have increased year-to-date, but generally not on a 12-month lookback. Meanwhile, the *liabilities* of those defined benefit pensions have risen faster.

A very long run of extremely low interest rates, including corporate bond yields, has dictated further cuts in the discount rates that plan actuaries apply to those future obligations. A lower discount rate raises the current value of those liabilities.

Of course, this is just a high level, more exacting version of a calculation we all face in assessing our retirement saving objectives. We can hope that when the time comes to support ourselves with our own nest eggs, we'll have the benefit of higher yields from relatively conservative investments. But that could prove to be a risky assumption. Returns are likely to reflect whatever a diversified blend of financial markets provides in a future defined by factors we can't control.

Like those large corporations, our inescapable imperative is to devote more *current* resources to the task of funding retirement. ■

Actuaries: More Fun than You Might Have Imagined

You've probably heard the old line about actuaries: They're good with numbers but lack the personality to make it as accountants.

OK, that's a cheap shot. In real life actuaries play a key role in the financial world, using probabilities and statistical records to help insurers and pension plans gauge their future liabilities and opportunities. Their work is the basis for designing life and annuity benefits, setting premiums, allocating institutional portfolios, and calculating pension funding and reserve requirements. Now they've come up with something fun for the *rest* of us.

The American Academy of Actuaries and the Society of Actuaries recently launched an online Longevity Illustrator, a free, easy-to-use planning tool at *www.LongevityIllustrator.org*. The Illustrator calculates the likelihood of living different lengths of time under varying scenarios. Life expectancy is often stated as one number based on a single set of assumptions. But many factors can affect longevity, so retirement planning ought to include a wide range of situations, risks, and contingencies.

If you want to liven up your next dinner party, or maybe you have a friend who's an actuary (*yes, they have friends!*), check out the Actuaries Longevity Illustrator. After all, we may be living longer, but none of us has *forever*. ■

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► *cont'd from page 2* / *Japan's Economic Struggles Obscure...*

to pay a premium for innovative, high quality products. That has been the overarching brand identity of Japanese producers for decades.

Highly capable Korean and Taiwan companies also have benefited, but new competition may be around the corner. Spreading prosperity across emerging Asia should pave the way for some of *those* countries to foster their own quality-oriented, innovative enterprises.

Human resources and a focus on innovation appear to be growing relative strengths. Aside from Japan and China, Asia boasts a younger population and rapidly rising educational attainment. Asian companies' share of global research and development spending passed their U.S. counterparts five years ago. Government policies have promoted the establishment of numerous research hubs with good infrastructure and skilled workers.

Five years ago, we noted that "Japan's... record of global competitiveness and resilience in the face of adversity merits some consideration." We might have added that for stock investors, where a company's prospective *customers* live can be at least as important as where the company lives. ■

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