



Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

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What Does The Downgrade Of U.S. Debt Really Mean?

Sentimental observations about the United States falling from a 94-year state of grace aside, Standard & Poor's recent downgrade of the Treasury's credit rating has real implications for investors and the nation.

In theory, a lower credit rating reflects a higher risk that an entity such as the Treasury will default on its debt or other financial obligations. To compensate lenders for the added risk, lower-rated borrowers generally need to offer higher interest rates. However, even though Standard & Poor's now considers U.S. debt no longer worthy of the top AAA rating, Treasury yields—the gauge of how much interest credit markets demand from the U.S. government—actually declined during the week following the downgrade. Although it may seem paradoxical, global investors still consider Treasury debt the safest place on earth to park their money in times of heightened risk, no matter what the rating agencies say. No foreign central bank is dumping our bonds; if anything, they're buying more.

In the longer run, if the Treasury fails to regain its AAA status, its reputation could eventually weaken, and U.S. interest rates may rise. On the eve of the downgrade, the two countries with AA+ ratings from S&P paid an average of 2.72% on their two-year bonds and 4.58% on their 10-year debt, compared with 1.12% and 2.65%, respectively, for the world's remaining AAA borrowers.

But averages can be deceiving. Switzerland, which S&P rates AAA,

pays just 0.06% in annual interest on its two-year bonds, and the United Kingdom, also AAA rated, pays fully 10 times as much—still a very low rate.



And then you get to Japan, which S&P rates two steps lower at AA—a full step below where the United States is now—and pays only 0.15% on its two-year debt. That's right: this lowly AA-rated country pays less than a quarter of what AAA-rated Britain offers, while interest rates for most other AAA nations are nine times as

high as what investors are happy to get from Tokyo.

Incidentally, the worst-case scenario S&P currently sees for the United States would prompt one more downgrade during the next two years, which would put the Treasury at exactly the same level where Tokyo is now.

Any upward trend in U.S. interest rates would also have to overcome the Federal Reserve and its new policy of setting the low end of the yield curve effectively at zero through mid-2013. As we have seen several times during the past few years, the Fed has almost endless funds at its disposal to buy Treasury debt and keep the government's borrowing costs artificially low.

Of course, other U.S. borrowers lack the infinite resources of the Federal Reserve. In the S&P system, the new U.S. rating means most U.S. companies, state and local governments and other bond-issuing entities are now also

(Continued on page 4)

Year-End Update

It is important to finish up any remaining 2011 tax planning soon.

Please contact us to estimate your income tax situation, suggest planning ideas, or simply to discuss any year-end questions.

December 31 is the deadline for Roth IRA conversions and College Savings Iowa contributions. We can assist in pension and IRA rollovers, or any required minimum distributions (RMDs) you may need to complete before year-end.

Dimensional Fund Advisors (DFA) has updated their brochure, "The Science of Investing" which details their investment model based not on speculation but on the science of capital markets. Kane Company shares in this mission to deliver the performance of capital markets and increase returns through state-of-the-art portfolio design and trading. This brochure can be viewed on our website at www.kanecompanypc.com.

Our office will be closed for the holidays on November 24th & 25th and December 26th. Also, our office hours will be extended in January through April 15th to accommodate our tax clients. Extended hours: Monday through Friday from 8am-5pm and Saturdays from 8:30am-12pm.

Thank you very much for your continued patronage and referrals. We want to wish all of you a happy and healthy holiday season, as well as a prosperous New Year!

Steven L. Kane, CPA/PFS, CFP®

Rising Tide: Emerging-Market Consumers

A wave of new consumers is building in the world's developing nations, a trend that offers great promise to U.S. investors.

Though developing countries face economic threats from political turmoil, inflation, and other challenges, Brazil, China, India, Russia, and many other nations in Asia, Latin America, and Eastern Europe have rapidly expanding middle classes hungry for electronic gadgetry, cars, and other consumer goods. Serving those booming markets has become a primary focus for multinational corporations such as Citigroup, whose

CEO Vikram Pandit noted in his annual letter to shareholders that "emerging markets are growing consistently faster than developed economies, in some cases by many multiples." Pandit named "the rise of an emerging market consumer" as the No. 1 global trend and said that Citigroup's top priority was to increase its share of emerging market business.

For individual investors, rapid growth in developing markets could translate into strong investment returns,

and making emerging markets one part of a balanced portfolio can help manage the risks of volatile regions. The key to tapping this new consumer demand is to understand where the growth is and the shifting opportunities and challenges of different regions. When conditions change, assets can be rebalanced among multiple emerging markets.

We follow these trends closely, and our analysis can help you find suitable ways to invest in global consumer growth. Consider these approaches for putting investment dollars at work in dynamic developing markets.

- Mutual funds and exchange-traded funds. Many mutual funds and ETFs are designed to give U.S. investors easier access to foreign

companies, countries, regions, and industry sectors. Many overseas funds invest a portion of their assets in consumer-related local companies as a way to capitalize on consumer growth trends.

Another variation is to invest in ETFs or mutual funds that concentrate on small-cap overseas companies, because such firms tend to benefit from growth in consumer buying power.

- U.S.-based multinational firms. A number of U.S. corporations are marketing more products and services overseas. When you invest in these companies, you tap their expertise in knowing which emerging markets will generate the strongest demand for consumer goods and services. ●

Where The Growth Is
(Year over year % change in economic output)

	2009	2010	2011 (proj.)	2012 (proj.)
Advanced economies	-3.7	3.1	1.6	1.9
Emerging economies	2.8	7.3	6.4	6.1

Source: International Monetary Fund World Economic Outlook Update, Sept. 2011

For example, stocks in Russia became more expensive after the recent political turmoil in the Middle East and North Africa. Investors poured money into Russia because it's the world's largest exporter of energy, and oil prices were headed higher. In light of Russia's suddenly loftier valuations, an investor could have reduced investments in Russia, taking profits after the market's rise, and redeployed capital to a region with more affordable equities.

Modern Portfolio Theory Is Alive And Well

For more than 50 years, Modern Portfolio Theory, or MPT, had been an article of faith for investors. The basic idea was that you could keep investment risk and reward in balance by choosing a diverse mix of assets. But then came the bear market of 2008 and 2009, during which nearly every kind of stock, bond, and most alternative investments plunged simultaneously. That led some analysts to pronounce Modern Portfolio Theory dead. What good is diversification, they asked, if everything sinks together?

But Modern Portfolio Theory never asserted that asset classes couldn't fall at the same time. Moreover, a look back over the past decade shows that investors who stayed

diversified, continuing to rebalance during the downturn, enjoyed healthy returns. In fact, the market meltdown has proven a powerful validation of MPT.

MPT asserts that the best way to maximize returns while minimizing risk over the long term is to allocate your money among diversified classes of investments and periodically rebalance to keep the proportions in line with original targets.

MPT attempts to build a portfolio of asset types that won't necessarily move together in response to changes in the economy. The hope is that when one portion of your portfolio—say, large-cap stocks—falls in value, another part—commodities, for instance—will rise. Rebalancing lets you

"buy low and sell high," because to keep allocations at proper levels you end up selling assets that have gained in value and buying others that have lost ground.

For long-term investors, one of the most distressing aspects of the 2008 economic crisis was the unprecedented way that nearly all asset classes—bonds, stocks, commodities—lost value at the same time. The notion that diversification ensures gains in some sectors despite losses in others seemingly lay in tatters. But diversification can't, in fact, ensure that outcome, and MPT never suggested it could. It can merely increase the likelihood of that result.

And even when, inevitably, there are times when every part of a portfolio loses

11 Planning Tips For The Rest Of 2011

How are you faring financially so far in 2011? Now is a good time to assess your situation and consider changes. Consider these 11 tips.

1. Spend only what you can afford. It seems simplistic, but many people, even those with substantial incomes, ignore this basic financial principle. If you have more money going out than you have coming in, it's a recipe for eventual disaster. To get things in balance may require trimming your spending or earning more. Are you being paid what you're worth? Can you get an additional, part-time job? Do you have entrepreneurial ideas that could bring in extra income? Making a few thousand dollars more each year could add up to a significant sum over your lifetime.

2. Make a budget and stick to it. This tip dovetails with the previous one. Regardless of how much you earn, it's important to know what you're spending and where the money goes. Track your expenses by keeping credit card receipts and noting cash payments. You may be surprised at how much you spend on certain items and monitoring your outlays could help you find easy ways to economize.

3. Avoid mounting credit card debt. One of the worst financial traps is to make large purchases on credit and then fail to pay off the full amount each month. Despite recent legislation to

reform rules on credit cards, your issuer can still impose double-digit interest rate charges on unpaid balances, sending your debt higher and higher and making it increasingly difficult to retire. If you have a large balance or two, consider consolidating your debt and putting away your plastic until you catch up.

4. Pay yourself first. This idea also needs to be coordinated with previous tips. But the main point is to set aside perhaps 5% to 10% of your income on a regular basis—before it gets spent. It may help to have the money automatically deducted from your paycheck and deposited into a separate account.

5. Invest your savings. It's not enough just to save money; you also have to put it to work for you. It's important to have an investment plan that considers your savings goals, when you'll need the money—for your kids' education, your retirement, or another objective—and how much investment risk you're comfortable taking. We can help you devise and implement an effective portfolio strategy.

6. Maximize employment benefits. Taking advantage of on-the-job benefits such as employer-sponsored health, dental, and life insurance could mean substantial savings. If your company offers flexible spending accounts, you can arrange to use pre-tax dollars to pay for

unreimbursed medical or dental expenses—and save as much as a third on those outlays.

7. Salt away money in retirement plans. Most employers let you participate in a 401(k) plan or another tax-favored retirement account. With a 401(k), you can defer part of your salary on a pre-tax basis to your investment account, and your company may match a portion of your contribution. Outside of work, both traditional and Roth IRAs can also help you build your retirement nest egg.

8. Convert to a Roth IRA. One downside to traditional tax-deferred retirement accounts is that you'll be taxed on distributions at a time when you may need all the income you can get. A Roth IRA, in contrast, doesn't let you deduct contributions but can deliver tax-free payments in your 60s, 70s, and beyond. You can convert traditional plans to a Roth, paying tax on the converted amount now to avoid liability during retirement. And because a Roth IRA doesn't require withdrawals, you'll have the option of preserving the account to pass along tax-free income to your heirs.

9. Review insurance policies. Don't make the mistake of being under or over-insured. For most people, the need for life and disability insurance is greatest during peak earning years and when there are children at home. But you'll need adequate insurance coverage even during retirement.

10. Create or revise your will. Your will is the road map to your estate plan, and if you don't have one, creating one is an absolute necessity. And an existing will may need to be updated, especially in light of the generous \$5 million estate tax exemption (\$10 million for married couples) available for 2011 and 2012. It's also important to have a power of attorney document drawn up in case you are unable to manage your own finances.

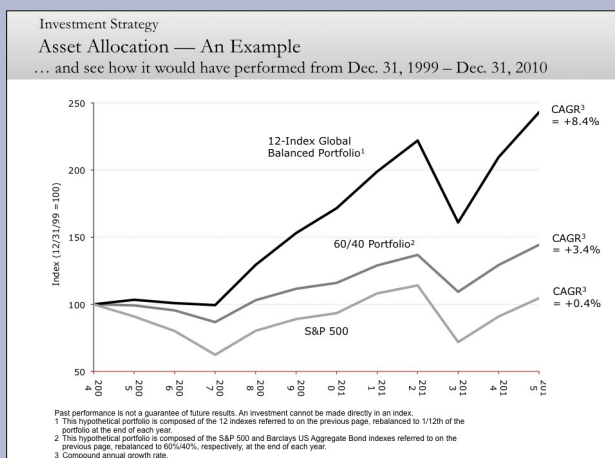
11. Get organized. Finally, make sure to keep accurate records and know where they are located. Developing a system for monitoring your finances should prove helpful for years to come. ●

value for a while, MPT has great potential value. According to economist Fritz Meyer, a global portfolio using 12 asset classes managed according to MPT principles would have earned a compound annual growth rate of 8.4% during the volatile decade ending in 2010, compared with a 0.4% gain for a portfolio holding only stocks (represented by the Standard & Poor's 500 index).

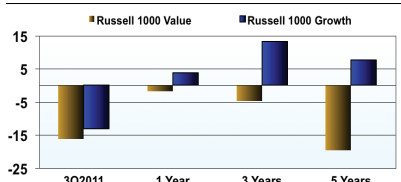
The secret is in the rebalancing, Meyer says, because disciplined rebalancing forces you to ignore macroeconomic considerations and keep emotions out of the process.

As we embark on another decade of

economic and market uncertainty, we will continue to design portfolios that are properly diversified and regularly rebalanced, allowing MPT to work for you. ●

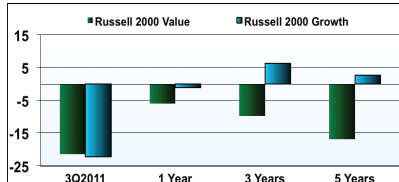


Market Data Bank: 3rd Quarter 2011



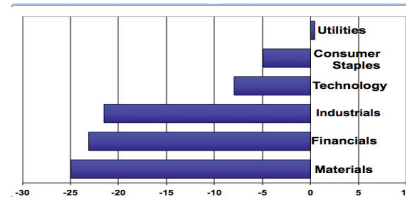
LARGE VALUE VS. LARGE GROWTH

Global economic concerns pushed shares of U.S. conglomerates lower in 3Q2011. While growth has fared better over longer time frames, value stocks remain depressed from 2006 levels.



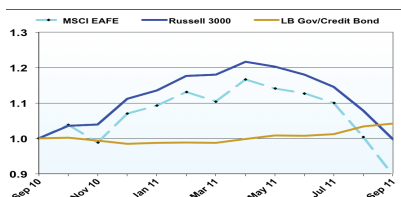
SMALL VALUE VS. SMALL GROWTH

Economically sensitive small-cap stocks joined the retreat. Here, too, traditionally growth-oriented technology and consumer stocks have held up somewhat better than their counterparts in the value group.



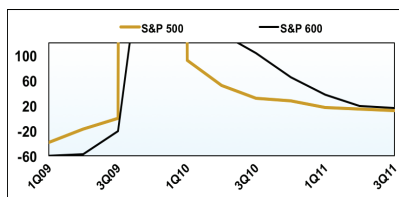
THREE BEST AND WORST SECTORS

Nine of the ten areas of the economy that Standard & Poor's tracks ended the quarter with often-severe losses. Only the ultra-defensive utility sector eked out a token gain for investors.



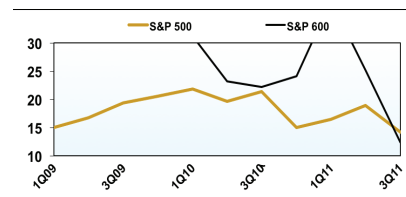
FOREIGN, US STOCKS & US BONDS

Weakness in the euro zone kept foreign shares on the defensive. By the end of the quarter, global stocks were down 10% on an annualized basis. U.S. shares were flat, while Treasury bonds outperformed.



LARGE VS. SMALL STOCK EARNINGS

While the economic expansion continued to slow in 3Q2011, reports of a steep decline in profitability were exaggerated. Large and small U.S. companies continued to grow at double-digit rates.



PRICE-TO-EARNINGS RATIO

Stock prices declined faster than earnings. By September, large-cap shares were fundamentally cheaper than they were in early 2009. Their smaller peers traded at an even steeper discount.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do not represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Downgrade Of U.S. Debt

(Continued from page 1)

subject to a maximum rating of AA+, and that has led to downgrades of many formerly AAA-rated borrowers. However, S&P has made numerous exceptions to its normal operating rules, leaving the AAA ratings on some states, cities, and corporations intact.

In explaining why it didn't downgrade all municipal issuers, S&P noted that "the institutional framework for U.S. public finance is among the most stable and predictable in the world." Meanwhile, the behemoths of American industry—including Johnson & Johnson, ExxonMobil, and Microsoft—are also considered unassailably reliable, and their AAA ratings are safe as well. And though the

entities whose debt was downgraded may suffer over the short term, the pain need not be permanent.

Standard & Poor's won't speculate on when or how the United States might get its AAA rating back, but other nations—Germany, Sweden, and Canada, among others—have rebounded from downgrades. It's often a slow process, taking as long as a decade, but if Congress can find the will to work out a sustainable budget that satisfies the ratings analysts, it can happen.

And that prospect in itself may be the silver lining in this situation. While



Standard & Poor's has been criticized by the President, Warren Buffett, and others for publicly challenging the will of one of the greatest economies on earth to pay

its debts, the challenge may be an opportunity in disguise. Any nation that owes 74% of its annual gross domestic product could stand to look seriously at its budget. If nothing happens to change the way the government spends, Standard &

Poor's calculates that we would owe 101% of GDP by 2021, which would put us roughly where Italy is now. This was a wake-up call. Now we can prove to the world how we became the greatest economy on earth in the first place. ●