Roth Your IRA Savings

William D. Starnes

Two years ago in this newsletter, I made a case for "tax diversification". Tax diversification means owning assets that have different sets of income tax rules associated with the accounts and their earnings. Tax diversification allows for hedging against changing tax laws, and the ability to better manage your current and future tax liability. For example, if you owned both a traditional IRA and a Roth IRA, you could control how much tax you pay on the withdrawal by deciding how much to withdraw from either your taxable (IRA) or tax-free (Roth) account.

The distinguishing characteristic of a Roth IRA (in contrast to a traditional IRA) is that you pay tax on the seed (the contribution), but you reap the harvest (the distribution) tax-free. With the traditional IRA, you deduct the seed, but pay tax on the harvest. Which seems like the better deal? Some people may say that it would be better to pay tax later in retirement since they feel they will be in a lower tax bracket. That is a myth. Most people are in a higher tax bracket in retirement given their retirement income, Social Security, pensions, and investment income.

One of the few things in life better than tax-deferred compounding is tax-free compounding. In fact, making Roth IRA contributions is a "no-brainer" if you qualify and have the available funds or cash flow. If you qualify and have the option of putting funds that are not needed into a taxable account or a Roth IRA, you almost always want to choose the Roth IRA. This is because your contributions (not the earnings) are always available for withdrawal, and 100% of the earnings are tax-free (but not necessarily available for withdrawal) for your life and all of your beneficiaries' lives.

> ***With the Roth IRA, you pay tax on the seed (contribution), but you reap the harvest (the distributions) tax free!***

Another benefit of Roth IRA's is that they are NOT subject to the minimum distributions rules requiring withdrawals at age 70 & 1/2. This applies not only during your lifetime but also the lifetime of your spouse (if they are a beneficiary). Therefore, the tax-free earnings build for far longer. Only when you die and leave the money to a non-spouse do withdrawals have to begin.

There are many more benefits, but let's move on to how to get as much money into a Roth IRA as quickly as possible.

Contributions

Anyone regardless of age can contribute to a Roth IRA if you have "earned income" and if your income is under $156,000 (with a joint tax return). In 2008, if you qualify, you can contribute $5,000/year ($6,000 if age 50 or older). Thus, even children with summer jobs can fund a Roth IRA based upon their earnings. Individuals over age 70 & 1/2 who are still working can continue to fund a Roth IRA.

Roth Conversions

A Roth IRA Conversion is when you move cash from a traditional IRA into a Roth IRA. Until 2010 there are income limits ($100,000) on performing Roth IRA conversions. After 2010, at this time, there will be no income limits. This will be the first time that most clients will have the opportunity to qualify for a Roth IRA conversion regardless of their income. The benefit of a Roth IRA conversion is potentially phenomenal. An estimate is that a taxpayer's family could benefit by as much as twice the amount converted.

You can convert as much of your IRA as you would like, but you will pay tax on the converted amount. This is the biggest roadblock for most people as you are paying an up front certain tax for a less certain future tax. However, don't avoid spending a little now to gain a lot for later. Sometimes, doing nothing because you can't part with the money is the surest way to build up your retirement savings account for Uncle Sam!

Also, if you convert an IRA to a Roth IRA in 2010, you have the option of spreading the tax over a two year time period. However, this may not be the best plan as in 2011 income tax rates are scheduled to increase.

Planning Tip: If you have no IRA's and don't qualify to make a Roth IRA <u>contribution</u>, you can open and contribute money to an IRA (but it won't be deductible due to your income) each year. Normally this is a bad idea. However, beginning in 2010 you can convert the

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Notices

Paul's Schedule / Newark Office:
Ed, Paul, and Susan are planning to attend the NAPFA Northeast regional conference in Hershey the week of November 10th. Also, we will be out for Thanksgiving and Christmas holidays.

Bill's Schedule / Hockessin Office:
Bill and his family will be away October 9th & 10th. Bill will attend the NAPFA Northeast regional conference in Hershey, November 10th—12th. Also, we will be out for Thanksgiving and Christmas holidays.

Next Newsletter:
The next newsletter is scheduled to be mailed in early January.

Behavioral Finance: Herd Mentality

Paul heard fellow advisor David Marotta speak at an industry conference a few years ago, and signed up for his newsletters. This August, David wrote a wonderful article on Herd Mentality, and we received his permission to share it with our readers:

One of the early studies on herd mentality was the Solomon Asch experiments in the 1950s. The setup was a mock vision test. In reality, all but one of the participants were actors, who after a few correct answers started agreeing unanimously on a wrong choice.

In a control group, participants had no trouble answering correctly. But participants waffled when a group of three or more people who preceded them confidently selected a different answer. Three out of four responded incorrectly to at least one question. In the end, participants answered incorrectly about 37% of the time.

First we must acknowledge that the phenomenon of the herd mentality can be useful in many situations. For example, computer simulations show that even when only 5% of the animals in a herd know the location of the watering hole, the entire herd is able to find it. In nature, keeping the number of leaders low helps minimize those who are put at risk. People use these instincts every day as they leave theaters and navigate crowded streets.

Although the herd mentality may help you find greener pastures if you are a bison, it won't help you find untrampled pastures. In investments, every bison ahead of you has already run the price up, and the only buyers of your investment are behind you. Straggling along at the back of the herd doesn't stop you from reaching the watering hole, but being toward the end of a run-up in the markets can be as deadly as drinking from fouled water.

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Mallard Announcements

Paul is scheduled for double, total knee replacement surgery on November 17th. He expects to work a bit from home the following week, and to return to the office on Monday, December 1st.

Jen Deery left the Newark office in August, to join her father's landscaping business. Diana Guinnup joined the Newark office later in August as the Office Administrator. She is in most days from 9am-2pm. Susan works Monday through Thursday, and this fall Ed is working on Monday, Tuesday, and Thursday.

Pam and Ed completed the one-year University of Delaware's Certificate in Financial Planning course in September.

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In the original Asch experiments, those who were persuaded to give wrong answers used two different sets of reasoning. One group believed that everyone was trying to give the right answer and they had somehow fallen victim to an optical illusion. The assumption that three presumably honest people are correct and you must be wrong could help you avoid some mistakes. The herd mentality can keep you from wandering off into the desert seeking to drink from a mirage.

The other group gave the wrong answer knowing it was wrong simply because it wasn't worth giving a different answer. Every time they broke the pattern of giving the same answer as everyone else, the cadence would stop and the entire group would look at them. They suspected that everyone else was wrong, but they saw no harm in going along and agreeing anyway. This is how the herd mentality can help your social life.

Even though a herd mentality can be useful in some situations, equity markets isn't one of them. In the markets, the herd effect benefits those at the front of the herd who can sell their place at the watering hole to those at the tail end before too many bison have fouled the water. Being at the tail end of the herd produces regret as the herd moves on, leaving you in a trampled field. But to avoid the pitfalls of this herd instinct in your investments, you need knowledge and conviction as well as an awareness of when you are susceptible to the influence of the herd.

In the original study, at least three actors were required to achieve this herd effect, and they had to be unified. If even one person gave the correct answer, it provided a role model for defiance and the herd effect was reduced. People seemed to need permission to disagree with the herd.

I give you permission to disagree with the herd. Countering the herd effect is the essence of being a contrarian, that is, an investor who buys a category when most others are selling and sells when others are buying. A contrarian doesn't chase what is hot but often buys a category that has recently underperformed.

Major news sources move markets just by their tone of optimism or pessimism. The financial news often focuses on daily price movements, and like all sports trivia, it tends to emphasize winning or losing streaks.

Stock prices can move on very low volume if it is all in one direction. Even when the vast majority of those who hold stocks continue to hold them, if even a few investors are motivated to buy or sell, the price moves significantly.

In the long term, the markets are brilliant at setting appropriate stock prices. In the short term, though, they have the IQ of a gnat. The markets offer so much inherent opportunity that even conservative investors get swayed by the siren songs of greed or fear. The strait between Scylla and Charybdis is a narrow path safely navigated only if you have a nymph like Thetis to guide you.

In the financial world, your Thetis is a long-term investment strategy and the discipline to purposefully avoid moving in one direction. Not following the crowd describes a contrarian perfectly. And the cornerstone of that role is rebalancing your portfolio regularly.

Imagine you have a $100,000 portfolio consisting of two different categories, A and B. Your wise financial advisor suggests diversifying your portfolio by investing half in each category. At the end of the first year, A has earned 30% and B has just broken even. You now have $115,000: $65,000 in A and $50,000 in B.

You are happy with your investment in A, but you still aren't sure about B. All the financial news is about A's stellar returns, how the industry is booming, and why A's products are essential to life on this planet. The news also reports the slump in Category B. No one is buying their products. They are laying off employees, firing CEOs, and facing a wall of pending indictments and lawsuits.

To make matters worse, your neighbor to the right works in Category A, and his 30% investment returns is all he can talk about. Your brother-in-law is dumping all of his investments in B and adding to his investment in A. So you call your financial advisor and ask if you should make some adjustments in your asset allocation as well.

"Yes," answers your financial advisor, "sell $7,500 of A and invest that in B." You are stunned. You wonder if your investment advisor is so stubbornly enamored by B that she won't admit her mistake and insists on pouring more of your investment gains down the drain.

Although you are not con-

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vinced by this so-called strategy, you decide to give it another try. So you sell some of A and buy more B. Now you have $57,500 invested in each.

Fortunes change. The layoffs and new leadership in B return profitability and the industry begins to recover. Stock prices, beaten down because of losses, rebound from their lows, and B gains 30% the second year.

Meanwhile, A's growth falters. Stock prices had been driven up from new investments and were pricing the company for 30% annual growth. When the industry of A only experiences 15% growth, however, the stock prices falter and appreciation ceases. Despite 15% growth, current stock valuations are barely justified and drift sideways for a 0% gain for the year.

Your brother-in-law and your neighbor to the right are tight-lipped. Your neighbor to the left, however, is ecstatic. He works for a company in B. Not only is his company doing better, his investment made a 30% return this past year!

You are satisfied but not ecstatic. You've never gotten a 30% return. You meet with your investment advisor and ask her, "If you knew B was going to do well, why didn't we put all the money in that category?"

"I didn't know B would do well," your advisor admits. "But when a good category falls out of favor with investors, rebalancing your portfolio is automatically a contrarian investment. Your portfolio returned 15% the first year and 15% the second year. Unlike your neighbors, the second year's gains compounded with the first year's gains produced a total gain of 32.5%."

You are amazed. The simple contrarian act of pulling money out of the investment that was the darling of the industry and investing it in the dogs of the industry boosted your two-year returns by 2.5%. Not only did your investments do better than your neighbors did, but you avoided the feast or famine volatility inherent in their approach.

As a financial advisor, I can often predict which category will perform the best over the next year just by observing the reluctance of new clients to invest in that category. A savvy Rothschild banker once gave this "contrary" advice: "Buy when there is blood on the street and sell on the sound of the trumpet."

It's tough being a contrarian, but investing in trampled on categories is too critical for your investment returns to let emotions or the herd mentality block your success.

MAROTTA ON MONEY by David John Marotta. David John Marotta is President of Marotta Wealth Management, Inc. of Charlottesville providing fee-only financial planning and wealth management

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balance of this non-deductible IRA to a Roth IRA since the $100,000 income limits will be removed at that time. And after three years, you will have $15,000 in your non-deductible IRA to convert (plus any earnings). The best part is that you will pay no tax on most of the converted dollars since the contributions were already taxed (this is called "basis"). You will only pay tax on the earnings. This is a low cost way to get a lot of money into the Roth IRA. This idea won't work nearly as well if you already have a regular taxable IRA with no "basis" in it.

If you don't have the "cash flow" to make a Roth IRA contribution, but at the same time have excess money invested in a taxable investment account, simply move $5,000 from your investment account into your Roth IRA. No "cash flow" is needed to fund the Roth IRA and you have converted all future income from taxable to tax-free!

As you can tell, I love Roth IRA's and always am looking for opportunities to help clients fund them (of course when it makes sense). You simply can't beat this strategy for building tax-free long-term wealth for the entire family—young and old.

Bill Starnes is the managing partner of Mallard Advisors' Financial Planning Division