The Mallard Flyer

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Notices

Newark Office:
Paul and Susan will be at a one-day NAPFA seminar on January 20th in Newark, NJ. Pam will be on vacation in San Antonio from February 4th to 7th. Paul and Susan will both be at a TD Ameritrade conference in Florida from February 3rd to 7th, and Paul will be at a Technology Tools conference in San Diego from February 17th to 20th.

Bill's Schedule / Hockessin Office:
There are no scheduled vacations / conferences for the next three months.

Next Newsletter:
The next newsletter is scheduled to be delivered in early April 2010.

Convert! Convert. Convert?

William D. Starnes

There have been a lot of articles trumpeting **Roth Conversions in 2010**. But this does not mean that you should perform a conversion. In this article I will highlight the changes occurring in 2010 and who may want to consider a Roth Conversion.

What is a Roth Conversion? A Roth Conversion is when you move money from a Traditional IRA to a Roth IRA. You pay taxes on the money moved in the hope that you pay less at the time of conversion than you would pay if you left the money in the Traditional IRA, and were taxed at the time of withdrawal.

What is the Catch? The problem with all of this is UNCERTAINTY. You are agreeing to pay a *certain tax now*, for an uncertain tax benefit in the future. Therefore, you want to maximize the potential that the certain tax you pay now will be a benefit to you. You do this by being reasonably sure that you are converting at a lower tax rate than the rate at which you will be withdrawing these same dollars.

What has Changed for 2010? Only TWO things have changed beginning in 2010. First, everyone can convert IRA's to Roth IRA's regardless of income. In the past, there was a $100,000 income limit. So, now many people must consider the benefits of performing a Roth conversion. Unfortunately, while Roth conversions are now available to many high income people, these are also the very people who are LEAST likely to benefit from performing them (since they are generally in a high current tax bracket). Second, the income recognized by the conversion can either be realized in 2010, or deferred into 2011 and 2012. This is another decision that must be made, but may be deferred until you prepare your 2010 tax return.

What Must be Considered with a Conversion? Many articles in the press may lead you to believe that you should convert your IRA's to Roth IRA's, but conversions must be done with considerable thought. Roth Conversions really highlight the benefits of using a fee-only comprehensive financial advisor as the

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Mallard Announcements

Money School Classes
Bill will be presenting two classes this quarter. The first is titled ***2010 Roth Conversions*** and will held at the Lamborn Library (the first floor of Bill's building) on Tuesday, January 12th, at 5:30pm. The second is titled ***Stop Acting Rich and Instead Become Wealthy*** and will also be held at the Lamborn Library on Tuesday, March 2nd from 6-7pm.

Newsletter Delivery Options
If you would like to receive this newsletter via e-mail, just let us know. You will receive the newsletter several days earlier than the mailed version.

decision encompasses the following broad areas:

- Financial Security—A conversion should improve your financial future
- Income Tax Planning – A conversion must consider the immediate and long-term tax consequences associated with it
- Investment Advice—A decision must be made as to what type of investments should be placed in the Roth IRA.
- Estate Planning—Beneficiary designations may be different for a Roth IRA vs. other investments. Also, some asset protection may be lost as a result of converting a 401(k) into a Roth IRA.

Consideration	Beneficial For Conversion	Not Beneficial For Conversion
How many years do you have until you retire?	10 or more	Fewer than 10
Have past contributions been deductible or non-deductible?	Non-deductible	Deductible
Do you expect to spend your IRA assets in retirement?	No	Yes
Is your income much lower this year than it normally is?	Yes	No
Will the conversion subject your Social Security income to higher taxation?	No	Yes
Do you have a taxable estate?	Yes	No
Is there a chance you will need to tap your IRA assets prior to retirement?	Yes	No
Do you expect your income to be higher in retirement?	Yes	No
Has your IRA incurred significant losses over the last year?	Yes	No
Do you have the cash needed to pay the conversion tax?	Yes	No
Will the conversion push you into a much higher tax bracket?	No	Yes
Do you have "room" to maximize your current low tax bracket?	Yes	No

What are the benefits of having a Roth IRA?

There are many benefits to having a Roth IRA including no minimum distributions, additional withdrawal flexibility, tax-free earnings, hedging future tax rates, and tax-diversification. The question, however, is if these benefits are worth paying for. Many clients and journalists are focusing on future tax rate increases and using a 2010 conversion at current tax rates to be a hedge against future tax rates. While this is one factor to consider, there is much uncertainty in predicting future tax rates. For example, higher future taxes may not apply to IRA distributions and may only affect *earned* income tax rates (given the large baby boomer voting block). Or perhaps a national sales tax will be used to generate future tax revenue.

Who is a Prime Candidate for a Roth Conversion?

Because of all this uncertainty, I feel it is best to perform Roth conversions when clients have dropped into an unusually low tax bracket and are therefore certain to be in a higher future tax bracket at the time of withdrawal. Pick the low hanging fruit! In my opinion, of all the considerations shown in the table below, this is the most important one. Those clients with adjusted gross incomes over $100,000 who are now eligible to perform Roth conversions typically are not in unusually low federal marginal tax brackets, and are less likely to benefit.

A drop in tax bracket can happen when required minimum distributions are waived for a year (as in 2009), when clients have paid large deductible medical expenses (as with entry into a retirement home), or have large one year downward swings in business income. Some of these events can drive clients' marginal tax rates down to 0%! About once a year, I encounter a client who can actually create taxable income by performing a Roth Conversion and pay only $1 of income tax! Of course we tactically convert even more IRA money in order to maximize the 10% or 15% marginal tax bracket. This is quite lucrative when we know they will permanently jump back into the 25%+ federal marginal tax bracket.

Other ideal candidates are those with large estates whereby a Roth conversion is used to reduce the taxable estate, thus subjecting the estate to lower income tax rates rather than higher estate tax rates. This area is also filled with uncertainly regarding the future estate tax.

While the benefits of a Roth IRA conversion could be considerable, clients must carefully weigh the upfront tax costs against the long-term tax advantages.

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

Lessons from 2009 & Resolutions for 2010

Paul S. Baumbach

While it isn't very novel, this article's topic is simply too compelling, given the year that we just survived.

It has been said that the best decisions come from experience. I am hopeful that the experiences that we have gathered in the past two years will serve us well in the coming years, and help us to make good decisions (or at least more good than bad decisions).

Lessons

Diversification Works, Sometimes—Bonds are commonly used to diversify portfolios, to complement the riskier stocks in a portfolio and thereby provide smoother results. Through diversification, investors seek to find investments that 'zig' while others 'zag.' More to the point, safer investments such as bonds are chosen in the hope that they will at least hold their value in times when stocks are falling. In the 2008 market meltdown, however, most bonds lost money; the average taxable bond fund fell almost 8% in the year through 11/30/2008.

Foreign stocks are also portrayed as complementing US stocks in a portfolio. During the same one-year period, foreign stocks fell almost 50% while US stocks fell closer to 40%. No diversification benefits were provided this time by foreign stocks.

Two areas held up quite well in the near-meltdown: Treasury bonds/funds and money markets/bank accounts. While you merely held onto your money in bank accounts, with long-term treasury bonds/funds, you actually made a nice sum during the downturn.

The lesson is that diversifying helps portfolios most of the time. There are times, often when you need it most, that diversification is effectively unattainable.

Fear, Pass it On—We like to find patterns where they don't exist, and find breaks in patterns when the pattern isn't broken. The most common case of the second situation is when investors are convinced that 'it is different this time.' The last case was during the dot-com bubble, when stocks of companies that were losing money every quarter were bid into the stratosphere (indeed, this is more the case of "Greed, Pass it On"). Many investors were convinced that earnings matter less than a good story. This time, the pattern that was rejected was that down markets are followed by up markets. The US and the global stock markets have fallen in the past (the Great Depression, World War II, the Cuban Missile crisis, the Arab Oil Embargo of the 70s, the 1987 Crash, 9/11, etc.), and in each case they recovered. Why was this lesson ignored by so many investors last winter?

I'm reminded of a scene in one of my favorite movies, It's a Wonderful Life, in which George Bailey is speaking to customers of his savings and loan during a panic. He says "Can't you understand what's happening here? Don't you see what's happening? Potter isn't selling. *Potter's buying! And why? Because we're panicking and he's not. That's why. He's picking up some bargains.* Now, we can get through this thing all right. We've got to stick together, though. We've got to have faith in each other."

The lesson is that it is very difficult to fight the crowd, but it is possible. We are almost literally hardwired to want to 'cut our losses,' regardless of the result that this approach has suffered in the past. Google the term 'amygdala' to learn about the part of our brain responsible for this behavior. I've discussed its impact on investors' decision-making in my March 16, 2009 conference call, and Mallard's October 2002 newsletter. My remedy is to conduct 'lifeboat drills,' by mentally exploring how bad you would feel if we encountered another 40% or 50% decline in the stocks in your portfolio, and mentally preparing yourself for taking proper steps, rather than emotion-driven steps. By preparing in advance, it should be easier to avoid bad crowd decisions in future emotional times.

Market Timing Isn't Dependable—I believe there is relatively dependable value to considering the current market conditions when determining how quickly to 'deploy cash,' and to determine when to emphasize one type of asset over another (small US stocks versus foreign stocks, for instance). While this qualifies as market timing, I consider it to be 'weak market timing.' I do not believe, however, that 'strong market timing'—shifting large portions of a portfolio from stocks to cash for instance—is wise. Doing so requires near-perfection on several fronts, 1) determining when to jump out of the market, 2) determining when to dive back into the market, 3) controlling the income taxes that often accompany such a large set of investment trades, and 4) minimizing transaction costs from such sets of trades.

Many investment firms pursued market timing in the past eighteen months. Most often, this involved selling stocks sometime late in 2008, after some of the worst damage occurred. While these firms reduced their client's 2008 losses a little, most often they were MUCH too late to rebuild their cli-

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ents' stock holdings in 2009, and this market timing cost their clients a hefty amount of money by missing most of the 2009 stock market rebound.

Resolutions for 2010 and Beyond

Continue to Adopt 'Firewall Investing'—I coined this term in March 2009 to describe a helpful perspective on retirement portfolios. Most portfolios have two functions, to produce income and to grow. You can generalize the cash and bonds as serving the first function, and the stocks, the second. With Firewall Investing, investors are encouraged to ensure that enough of the portfolio is invested in cash/bonds to provide for several years of necessary withdrawals (perhaps 5-7 years for those who are retired). When that is done, in advance of a bad stock market, investors can more calmly determine what to do with their stocks. I am hopeful that better decisions (avoiding the general panic) should result from adopting a Firewall Investing approach.

Stick to Basics—Tried and true approaches work because, well, they are tried and true. Write down your investment and savings goals. Refer to them periodically, especially at times of rising, and falling, stock markets.

Set an all-weather asset allocation for your portfolio, whether it be 80% stocks and 20% cash/bonds, or vice versa. You can permit yourself to gently boost and cut back the level of stocks, as the conditions change, but work on maintaining the course you set for yourself. You can also build in a designed reduction of risk as you age, but again, write it down and stay with the approach (Yogi Berra: "Plan your play, and play your plan.")

While diversification is far from perfect, the best single determinant on your portfolio's future results is the proportion that you direct to stocks. Stocks rose from 27% to 37% last year. Bonds rose over 10%. Money markets and bank accounts? Don't ask! This is the almost complete reversal of 2008's results. However it clearly illustrates that it is more important to select how much of your portfolio you are willing to direct to stocks/stock funds than which stocks/stock funds.

Understand the Source—A report on NPR last month noted that forty years ago most Americans received the bulk of their news from the three major network newscasts (the heyday of Walter Cronkite). Now, there are so many cable channels and internet sites that you can essentially choose your answer, and then select the 'trusted source' to confirm your views. You can identify 'permabulls,' who feel that stocks are destined to go up, up, up (such as Wharton's Jeremy Siegel, author of Stocks for the Long Run) and 'permabears,' who feel that stocks are destined to go down, down, down (such as GMO's Jeremy Grantham). Don't get me started about Jim Cramer!

Note that the top priority for most newspapers, radio talk programs, and cable TV programs is readership/ viewers. It is sometimes called **edutainment**. Delivering accurate, useful information is not on their short list. When I was approached to be a guest on Fox Business News this past summer, the producer noted, "The aim of the segment is to advise investors where they can 'make money now', and I look for something a bit spicier than the same-old 'proper allocation/diversification strategy.'" Is this the source that you want to depend upon for quality information (except for when I'm on, of course)?

Be an educated consumer of economic/market analysis. The highly partisan environment in the US leads much economic and market analysis to be quite one-sided. There are many left-leaning and right-leaning think tanks, whose analysts frequent the airwaves, print, and internet. Similarly, economists who work for brokerage firms (Goldman Sachs, JP Morgan, etc.) can also have an agenda, most often to encourage investor optimism. Treat them all with a grain of salt, first understanding who signs the analysts' paychecks. This is the exact reason that we established Mallard as a Fee-Only™ firm, so our clients know that our advice is untainted by pressure from our employer, the way a broker's advice can be. There is value to considering the views of many of these outlets; however, each requires that you understand the source, and their motivation, while 'consuming' their analysis.

The Firewall Investing approach, coupled with a 'lifeboat drill,' should enable you to better avoid the temptation to try full market timing or to make other investment decisions at emotional times, decisions that you could regret later. 2008 and 2009 brought many restless nights. Resolve in 2010 to sleep better during future turbulent times. Turning off the cable financial news may be the first step.

Paul Baumbach is the managing partner of Mallard Advisors' Investment Advisory Division.