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The Sensible Investor

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Roth Conversions Are Not For Everyone

By George P. McCuen, CFP®, President

About a year ago the financial press, as well as banks, brokerage firms, mutual fund companies, financial planners and others, began touting the new rules for converting IRAs to Roth-IRAs. In 2010 the income limits have been eliminated for those wanting to convert their IRA to a Roth IRA opening up the potential for anyone with an IRA to make the switch. To sweeten the pot, the IRS is allowing anyone who converts two years to pay the tax bill for the conversion. Due to the concern shared by many that tax rates will be higher in 2011 and beyond, you can convert your IRA in 2010 and pay the entire tax due from the conversion at your 2010 tax bracket, but that should be reviewed with your tax advisor before making your decision.

Jim Riley, our resident tax professional, performed an experiment recently. Jim went to a popular mutual fund company's web site and found their Roth conversion calculator. He ran several hypothetical scenarios to see how the calculator would respond. In every case the program suggested the client convert. Puzzled by the notion that every faux example would generate the same advice, Jim's input included examples that were certain to generate a "don't convert" response, but to no avail. The Roth conversion calculator seemed to be hard-wired for a 'convert' response. Of course the credibility of this calculator was tainted because we know there are many reasons to not convert an existing IRA to a Roth-IRA. Let's look at a few.

The most revealing reason to not convert is due to the size of the immediate tax caused by the conversion. One of the biggest questions you must ask yourself is whether paying taxes is feasible right now – or over the next two years. <u>You do not want to use funds from your IRA to pay the taxes.</u> Ideally you would use money from other sources, typically other investments, to cover the tax bill generated by converting your IRA. If you don't have the money to pay the tax on the entire conversion, another option would be to convert over time.

Age can make or break an investor's ability to profit from a Roth-IRA conversion. If retirement is too close you may not be a good candidate for converting. The problem is that it can take many years for the tax-free growth of a Roth-IRA to make up for the taxes paid at the time of conversion. It is not all black and white when it comes to whether or not to convert to a Roth IRA. One component that does help with the decision is time and the longer, the better.

Converting when your savings are concentrated in retirement accounts is usually ill-advised. When you have a disproportionate amount of assets in retirement plans, it wouldn't be wise to convert 100% to a Roth-IRA because you most likely will be pulling money out to live on soon if you are near retirement. A partial conversion might make sense for the IRA savings that you wouldn't need for a long time, if ever.

Interest in conversions is being spurred by anticipation of higher tax rates ahead. Some investors figure they will come out ahead by converting to a Roth-IRA now and paying taxes at current rates rather than leaving their money in a traditional IRA and paying taxes at a higher rate when they make withdrawals in the future. While some investors will be in a higher tax bracket in the future, some may fall into a lower bracket when they retire.

Another tax bracket issue to consider: a conversion could bump you into a higher tax bracket because the money being converted is treated as income in the year of the transfer. This could cause Social Security benefits to become taxable. For younger families, it could interfere with efforts to receive financial aid for children's college

tuition. If an investor is going through a divorce, the additional income could affect the settlement.

There are many situations when a Roth conversion makes financial sense. Having a long-term time horizon for the money to grow tax-free can be ideal. As an estate planning tool, it works marvelously. When you desire to cap the taxes paid on your IRA, even if you are in the highest tax bracket currently, this technique can save your family thousands if not tens of thousands of dollars over a generations life span.

As you can see, a Roth conversion is not a decision that should be made flippantly. Jim's cursory research of a popular web site's calculator brings home a point that such a decision should not be made without proper research and in our opinion without good tax council. If you or someone you know have questions about a Roth conversion, please give Jim a call or email jim@napawealth.com. Together with your tax advisor, Jim is well equipped to help you through this potentially wonderful opportunity, or prevent you from making a decision that is not in your best interest.

What Are the Correct Mix of Stocks and Bonds in My Portfolio?

By Tim L. Ayles, Chief Investment Officer

If you are faced with investment options for retirement savings, you most likely have asked yourself this question. The conventional wisdom that is popularly followed in the investment world is that you want the percentage of your bond holdings to equal your age. Thus, a 35 year old will have a portfolio of 35% bonds and 65% stocks. A 70 year old investor would have 70% bonds and 30% stocks. Sounds simple enough. The logic behind it is the older you get, the safer you should be with your investments. On the surface, bonds are supposed to be much safer than stocks.

When I am asked the investment question about bonds equal to your age in percentage terms, I usually try to explain that I don't buy the theory outright. The reason? I look at the value of an investment. Here is an example. If the Dow Jones dropped to a value of 100 from the current approximately 10,000, and the bond market rose many hundreds of percent from here so that the 30 year bond was yielding .10%, would it be smart to put 90% of a 90 year old clients money into the bond market and only 10% into stocks, simply because of their age? I don't think so, from my point of view. So somewhere in the middle, someone needs to do the hard work of figuring out when a stock is more valuable than a bond, and vice versa. Investing requires hard work, so don't become into a made up formula you read about in a popular money magazine.

One example I like to give is the current situation we find ourselves in with blue chip stocks. Johnson & Johnson (JNJ) for example, currently pays more than a bond as it yields 3.74% as of 8/30/2010. The yield on the 10 year Treasury bond is sitting at 2.54%. Someone who is retired needs income to pay their bills and buy their food. Would you rather put your money into a bond at 2.54%, or buy Johnson and Johnson with a dividend yield of 3.74%, 1.2% more than the10 year Treasury and protects you a little against any money printing our FED has up their sleeves?

Take the time to do the homework, or find an advisor who will. Although we still feel the market has more pain ahead, when we can buy a higher income stream from a bell weather stock like Johnson and Johnson, versus a 10-year Treasury bond, we are willing to own a stock instead of a bond. In the long-run we feel this makes sense. ◈

Tim's articles have been published on Seeking Alpha's website. Check out Tim's three part series on depression era investing at www.seekingalpha.com.

Fall Open House

Friday, September 24th from 5-7:30

Come enjoy live jazz by Canned Music Trio

food by La Taquiza.

We hope to see you there!