

# PORTFOLIO WATCH



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Fee **FO** Only

## IRA Conversion – The Big Decision For 2010

A significant tax law is about to change in January that leads to a bunch of possible retirement saving strategies. The earnings limit for being able to convert a Traditional IRA to a Roth IRA goes from \$100K/yr to non-existent. This will allow people who currently have all of their retirement savings in accounts that will eventually be fully taxable (IRA, 401k, 403b, etc) to set aside a bucket of money that will be tax-free in retirement. This month I want to explore a reason you may want to consider this.

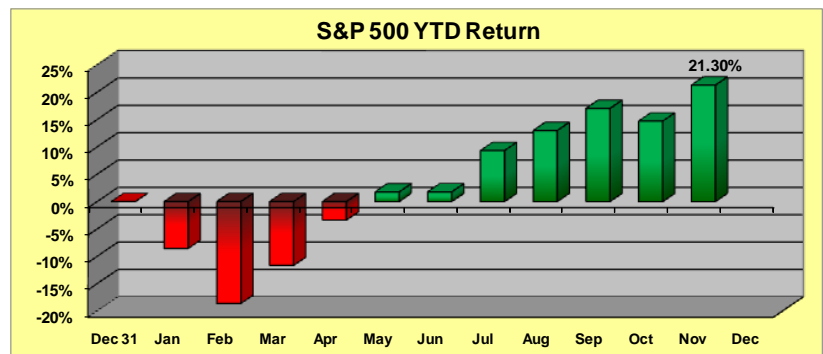
### Tax Rates

The decision to convert to a Roth IRA begins and ends with tax rates. The amount of the conversion is added to your current income for the year, so it is taxed as ordinary income. If you do the conversion in 2010 you have the option of paying the taxes in 2010, or split the taxes 50/50 between 2011 and 2012 (at whatever tax rates will be for those years). So a conversion is a bet that taxes are lower now than they will be in the future.

It's difficult to compare historical tax rates, because not only does the percentage change, but the income brackets change as well. In 1942, the top tax bracket was changed from \$5M (equivalent of \$66M today) to \$200,000, or \$2.6M in today's dollars. So even though the top tax rate was 94%, it didn't apply to very many people. Below is a comparison of the federal tax rates at different earning levels for a Married Filing Jointly taxpayer, adjusted for inflation to today's dollars.

	\$50K/yr	\$100K/yr	\$150K/yr
1970	17.77%	21.21%	24.93%
1980	15.74%	24.71%	30.81%
1990	15.00%	21.02%	24.03%
2000	15.03%	20.86%	23.57%
2010	13.33%	17.36%	20.16%

2006 return: 13.62%    2008 return: -38.49%  
 2007 return: 3.53%



### Are Taxes Going Up?

As you can see from the chart, taxes are currently the lowest they've been in the last 40 years. In addition, the tax rate on Long-term Capital Gains has not been this low (15%) since 1933, and is due to go to 20% in 2011. Even though tax rates are currently low, we don't need to worry too much about increasing rates as long as the national debt stays reasonable. Let's take a look at how that's going.

- Debt as a % of GDP in 1980: ~35%
- Debt as a % of GDP in 2010: ~80%
- Nat'l debt in 1980 (infl. adjusted): \$2,397,000,000,000
- National debt today: \$12,168,300,000,000\*

\* add about \$3,000,000 each minute

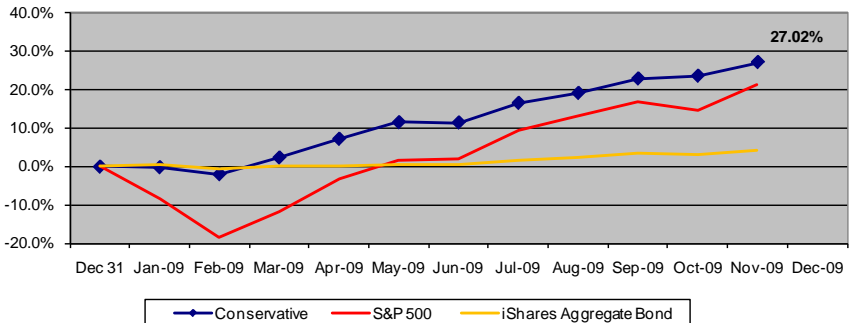
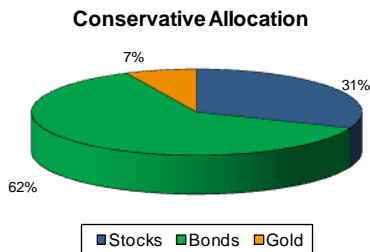
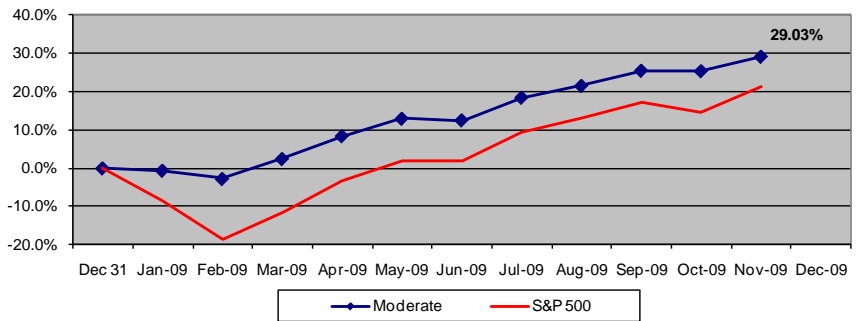
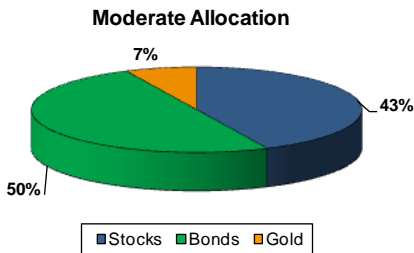
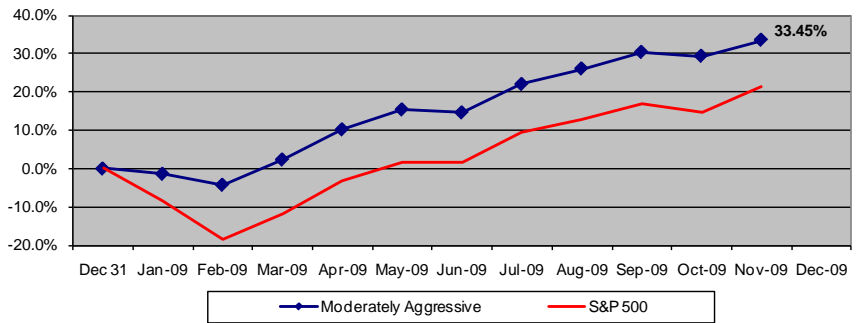
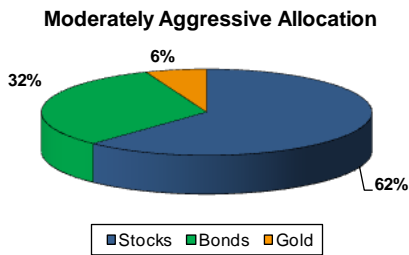
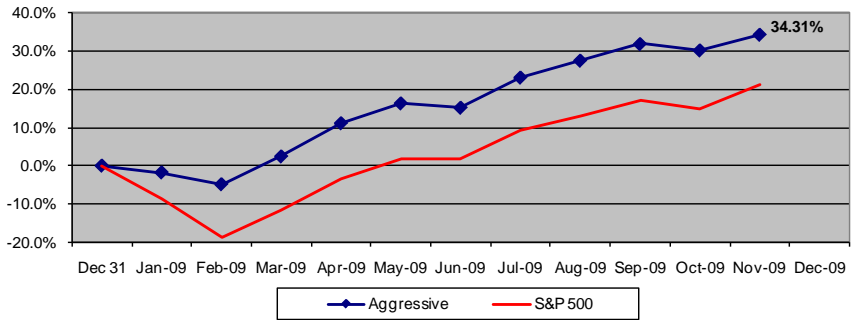
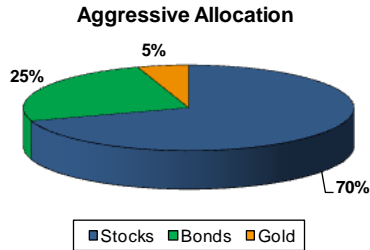
It doesn't take a math wizard to figure out that something has to give with respect to taxes, but *when* tax rates will go up is anybody's guess. For now, it's just easier to push the problem to the next generation.

### The Decision

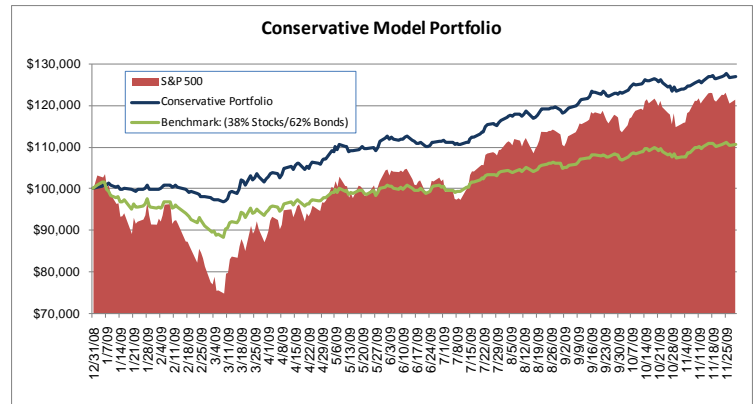
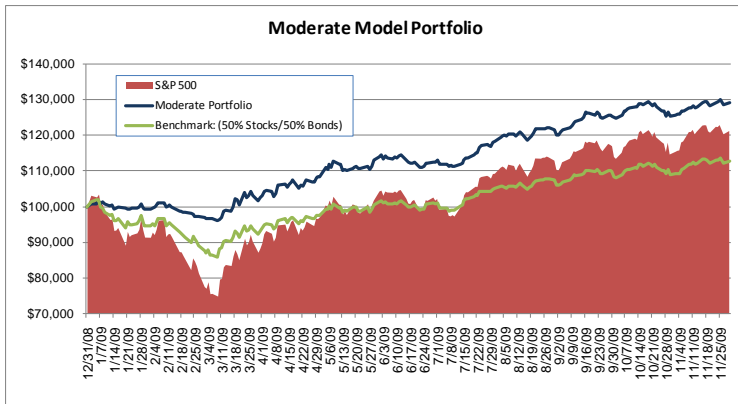
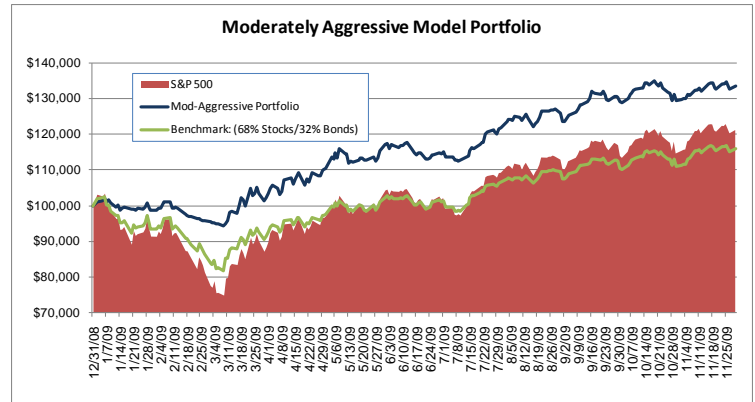
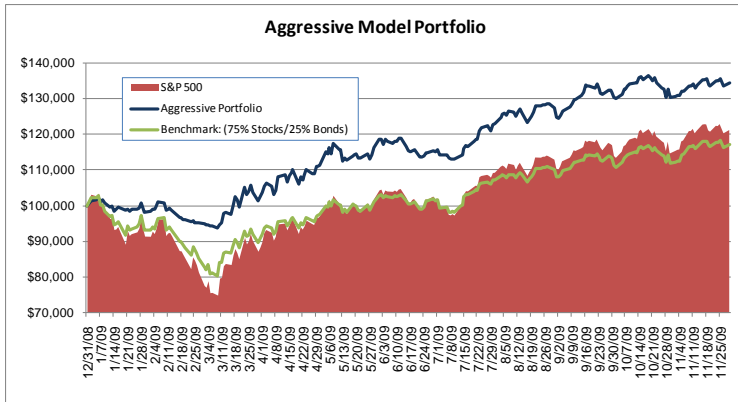
The decision to convert a Traditional IRA to a Roth IRA is not an easy one. It clearly involves assumptions and guesswork about events in the distant future, which is why I advocate hedging your bets with at least some money that will be tax-free. What is clear is that early in 2010 is the best time to make the decision, since that is when you have the most options. Taxes can be paid in 2010, split between 2011 and 2012, or the entire conversion can be undone as late as October 2011 with no penalty. More discussion to follow.

# Model Portfolio Performance

The following allocation models and Year-To-Date performance graphs represent the preferred investments in Veripax Financial Management's target portfolios. Investment allocation for each model is determined based on time horizon and risk tolerance. In most cases, individual client portfolios will contain slightly different investments and allocation mixes based on individual financial goals, investment priorities, and tax considerations. The Model Portfolios invest primarily in Exchange Traded Funds and no-load bond funds.



# Daily Performance Charts



**Benchmarks:** The Benchmark for each of the above graphs utilizes the Russell 1000 Index for stocks and Total Bond Market Index for bonds. The ratio of stocks and bonds in each Benchmark matches the ratio of the associated VFM model portfolio.

**Portfolio Construction:** Each Model Portfolio consists of up to 8 stock sectors, 7 bond sectors and gold. Buy/Sell decisions are based on VFM's proprietary algorithm and are consistent across all portfolios. Each Model Portfolio and the associated Benchmark are rebalanced quarterly.

## Portfolio Comments

November brought the market and all of the model portfolios to new highs. The S&P 500 is up 21.3% for the year, and 62% since March 9. In financial professional language, that's considered a lot. The overall market continues to show signs that it may be getting tired. The S&P 500 tried several times to stay above 1120, but was never able to close above that level. This indicates that there are plenty of people willing to sell at this level. December has traditionally been a good month for stocks, but the market has been pretty good at ignoring anything it's "supposed" to do.

All portfolios made gains for the month. Equities significantly outperformed Fixed Income, so the portfolios lost a little ground to the S&P 500, but each one made further gains compared to its diversified benchmark. It looks pretty clear that all of the portfolios will end up beating the overall market for the year.

Gold was the big winner for the month with a 12.79% gain. Basic Materials was also a double-digit gainer (10.77%), and Healthcare almost made it to double digits (9.30%). Energy was the worst performer out of the equity sectors by gaining only 2.84%. Materials, Financials and Small Caps all went to cash briefly early in the month, but then turned around and headed back up again. With all of the portfolios outgaining their respective benchmarks, the fake-out obviously didn't hurt much.

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