

# PORTFOLIO WATCH



Email: [Jerry.Verseput@veripax.net](mailto:Jerry.Verseput@veripax.net)  
 Phone: 916-358-5635  
 Website: [www.Veripax.net](http://www.Veripax.net)



Fee **FO** Only

## IRAs/401Ks – The Government Loan You Didn't Know You Had

I don't normally talk bad about IRAs and 401k's. After all, they help people save, think long-term, and they make up the bulk of my business. The problem I see a lot, however, is the idea that tax-deferral is the best thing since sliced bread (why sliced bread is so great is another question), and that tax-deferral "let's your money grow faster". Hogwash (although that's not the word I was thinking of). It is much better to think of tax deferral as a government loan that they would like you to invest for them. Let me explain.

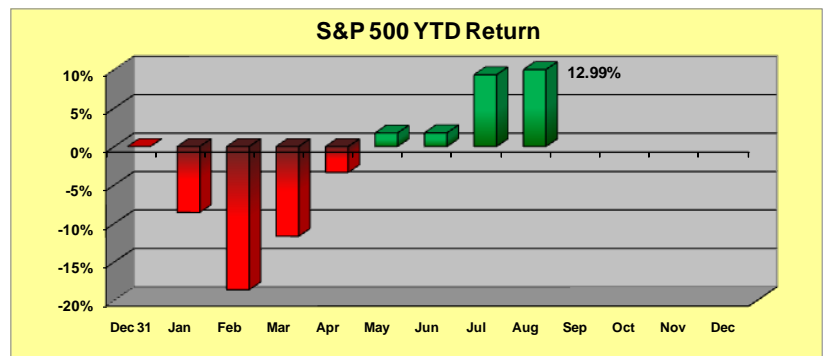
### The Money Isn't Yours

I'm going to use an IRA as an example, but everything can be applied to a 401k, 403b, or any other tax-deferred account. If you contribute \$5000 to an IRA and you're in the 25% tax bracket, \$1250 of that contribution belongs to the federal government. You get to keep it...for now, and as it grows it will make your account look bigger, but that piece of your account will always belong to the government. If the \$5000 grows to \$50,000 by the time you need it and you're still in the 25% tax bracket, the government's piece will have grown to \$12,500. In other words, you simply invested it for them. Tax deferral did not make your account grow faster or put more money to work for you.

### The Advantage (or Disadvantage)

Tax deferral is only an advantage if the government decides to take a smaller piece of it when you withdraw the money. If your tax rate is lower when you need the money, then essentially the government has decided to not take back their entire share. In that case you have beaten the system. However, if tax rates go up, or you need substantial income when retired, or tax brackets don't keep up with inflation (a way to raise taxes without the political ramifications), the government could require a larger share of

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



your IRA. In financial terms, this is known as "bad". So tax deferral is really a bet on future tax rates and how much income you will need in retirement.

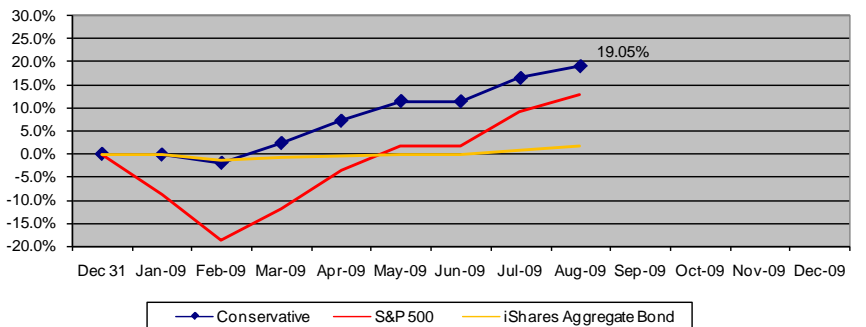
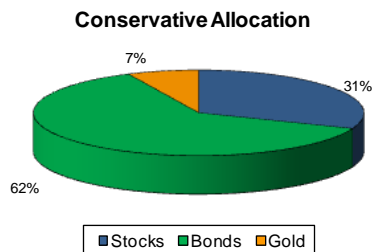
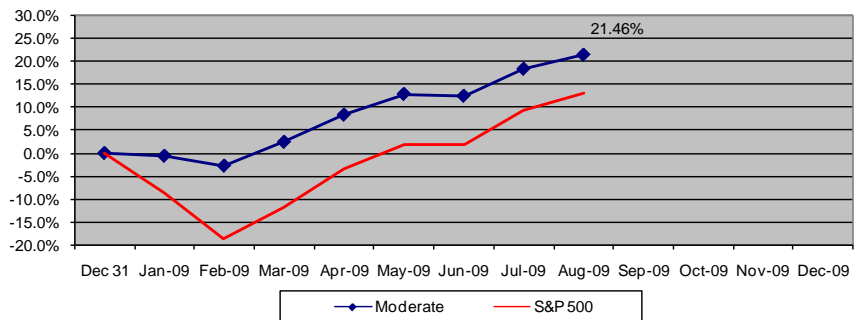
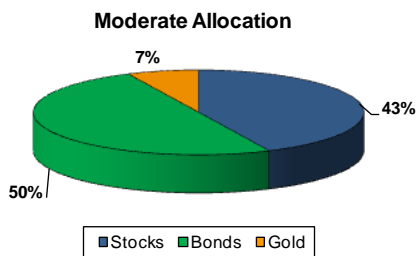
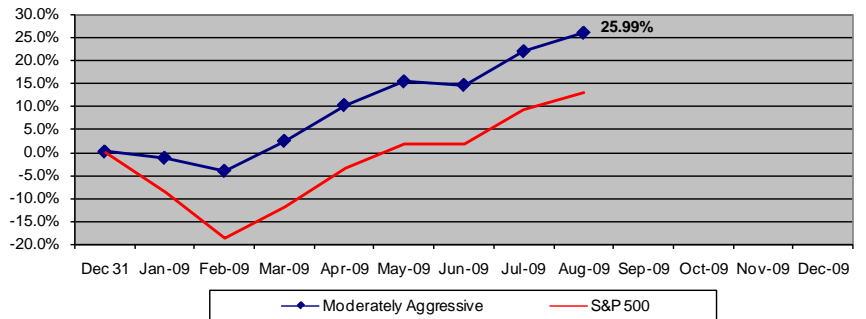
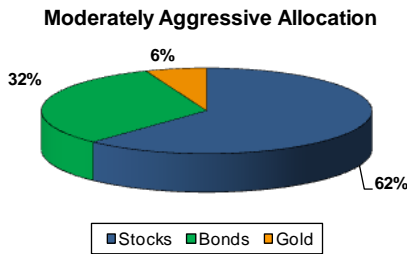
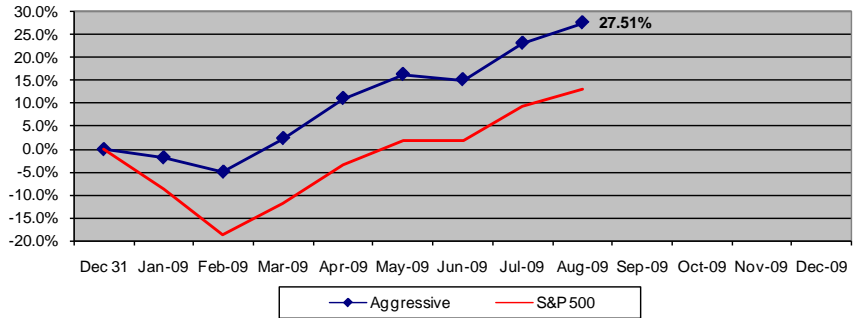
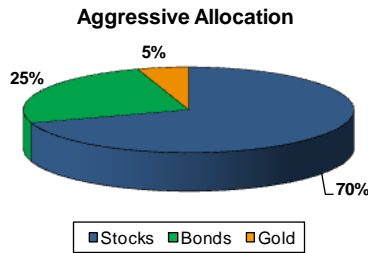
### Theory versus Reality

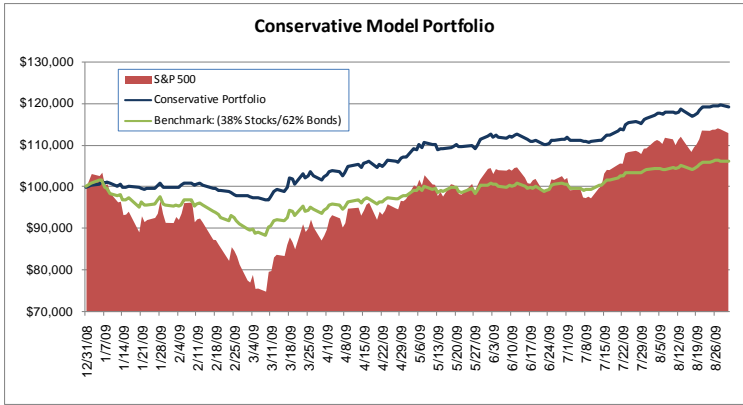
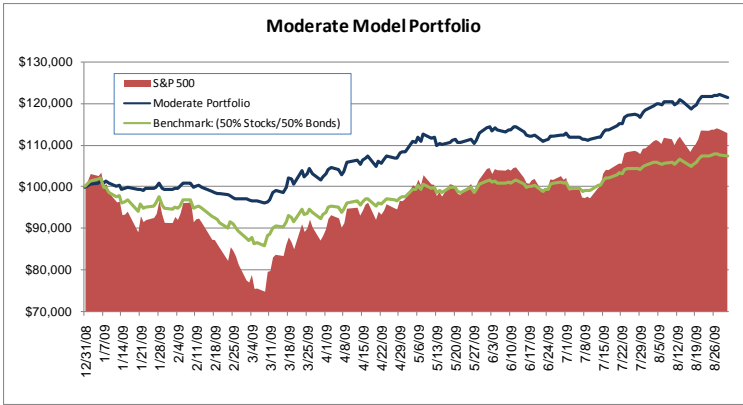
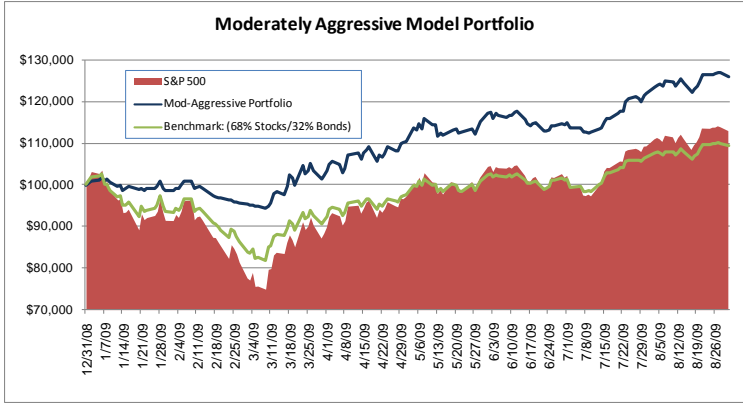
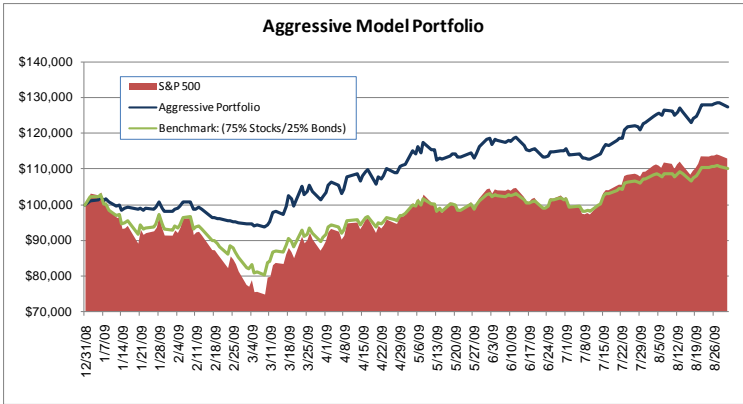
When people compare Traditional IRAs and Roth IRAs, they typically assume that more money goes into the Traditional IRA because of the tax deduction. However, in real life, most people end up investing the same amount whether it's a Traditional or Roth IRA (the same applies to 401k's). The money that was contributed to the Roth was simply taxed as part of a paycheck, so the taxes were paid with "outside funds" – money that's not earmarked for retirement. In theory, the taxes you will eventually pay on the Traditional IRA could also be paid with outside funds, but only if you diligently saved the money from the tax deduction and it grew at the same rate as the IRA. Not likely. In most cases the taxes on a Traditional IRA get paid with retirement funds. So the net result is that more actual retirement money can be put into a Roth IRA or Roth 401k, effectively increasing the limits for retirement savings.

This is not an argument for or against 401k's or IRAs. I'm just pointing out that if anyone gets all giddy about the benefits of "tax-deferred growth", it is simply a bet that your tax rate will be lower in the future. Your money is not growing any faster, and in fact, tax-deferred accounts almost force you to pay the taxes with money earmarked for retirement. If you're thinking "I wish I would have thought of this earlier", it's not too late. Starting next year, anyone can convert a Traditional IRA to a Roth IRA. If you can pay even a small part of the taxes with outside funds, this may be a great way to save more money for retirement.

# 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.





**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

August was another great month for the market, although a few cracks started showing in the last week. Most analysts and advisors have been predicting a correction for quite some time, and when everyone is thinking one way, the market is notorious for doing something else. In any case, the market handed us another good month, so we'll take it.

There wasn't a lot to do this month in terms of money management. The market is in an uptrend, and as long as that continues we will stay invested. All of the portfolios remained firmly above their benchmarks, with the Aggressive Portfolio ahead of the S&P 500 by about 14.5%.

Once again, every sector made gains last month. Real Estate had the biggest gain at 14.32%, followed closely by Financials at 12.05%. Everything else was in the 1%-4% range. This is a great argument for the strategy of maintaining an even distribution across all sectors. Most mutual funds maintain over-weighted positions in the 2 or 3 sectors they believe will outperform all the others. I'd be willing to bet one of their over-weighted sectors is NOT real estate.

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