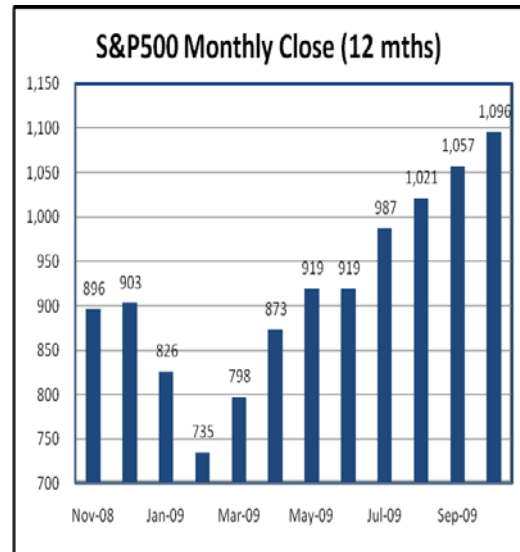
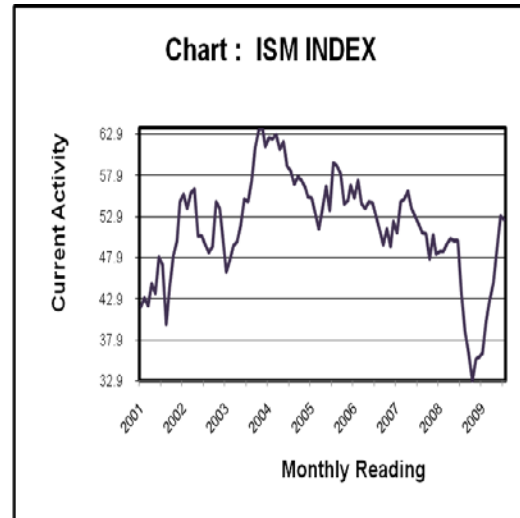
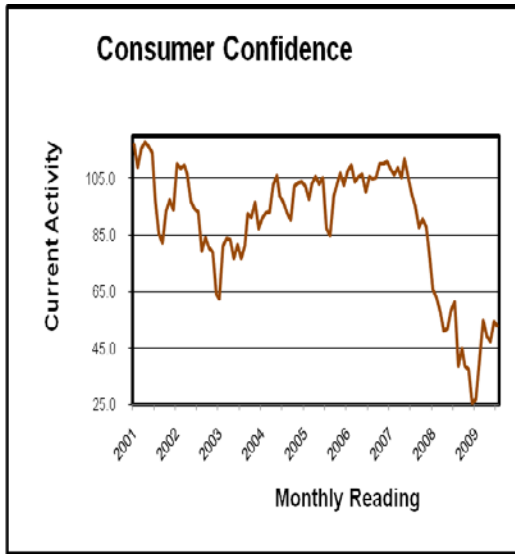


# YSWM, LLC

## Client Letter



Financial Market Update

IRA Roth Conversions in 2010

Tax Changes for 2010

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October 16, 2009

# YOLLES-SAMRAH WEALTH MANAGEMENT, LLC

Your third quarter performance report is enclosed and shows solid gains for the third quarter as well as a double digit gain year to date 2009.

## **FINANCIAL MARKET UPDATE**

In the third quarter, stocks continued their seven month rally since bottoming on March 9<sup>th</sup> at 676, with the S&P 500 Index advancing 15% during the quarter and 56.4% from the bottom to the 9/30/09 close at 1,057. As shown in Table 1 below, international and smaller cap indices have enjoyed even larger gains than the S&P500 which has advanced another 39 points or 3.7% to 1,096 by Mid-October.

The rapid and unpredictable movements of the market as experienced both up and down during the last twelve months illustrate once again that market timing is very difficult. The S&P 500 began the year at 903, and then declined 25% to 676 only to recover back to 919 by the end of Q2. In early July stocks fell back heading into the Q2 earning's reporting period then eventually exploded higher in mid-July. The market has yet to look back despite many pundits' predictions of the looming crash and recent deceleration in numerous confidence indicators, home prices and nonfarm payrolls.

<b>Table 1 - Benchmark Returns</b>		
<b>Index</b>	<b>3Q09</b>	<b>YTD 9/30/09</b>
S&P 500	15.0%	17.0%
Small Cap 2000	18.9%	21.0%
International (EAFE)	18.8%	25.5%
Total Bond Market	3.7%	5.7%

**Table 1** summarizes the benchmark rates of return for both the third quarter and year-to-date. International and small cap (Russell 2000) stocks led the way in Q3 with Total Bond Market Index also generating a strong 3.7% gain as both Treasury and corporate bond prices rallied pushing yields down. The dollar was the main casualty as the U.S. Dollar Index has fallen from over 89 in early-March to below 76 by Mid-October.

The falling dollar provided a significant boost to already strong international returns for U.S. investors as they benefited from the appreciation of foreign currencies. For example, the S&P Europe 350 Index is up almost 20% YTD in Euros but up over 30% YTD in U.S. dollars due to a 10% Euro currency gain relative to the U.S. dollar.

<b>Table 2 - 2009 Sector Returns</b>	
<b>Benchmark</b>	<b>YTD Return (9/30)</b>
Health Care	10.4%
REITS	14.1%
Asia	19.3%
Financials	21.1%
Europe	26.6%
Mid Cap	30.6%
Technology	36.7%
Basic Materials	37.6%
Emerging Markets	57.0%

Year to date total returns through 9/30/09 for some key sectors are shown in **Table 2**. Note that the divergence in returns between the best and worst performing sectors is substantial and illustrates the benefits of diversification. Emerging Markets led the recent advance with a 57% year-to-date gain as of 9/30/09 as compared to the S&P 500 up 17% YTD. Emerging market economies tend to be large exporters of

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raw material and materials was one of the top performing domestic sector up 38% YTD.

Clearly the weak dollar and its source, very low U.S. interest rates, played a large role in the outsized international and emerging market returns for U.S. investors. Technology companies with high cash positions and low or no debt balance sheets have been in favor during 2009 while health care and REIT returns have lagged most benchmarks.

Table 3 summarizes domestic fixed income returns. The divergence of returns again illustrates the importance of diversification even for bond investors which have rallied from depressed levels after the sharp flight to quality in 2008.

<b>Table 3 - Fixed Income Returns</b>	
<b>Benchmark</b>	<b>YTD 9/30/09</b>
Intermediate Treasury	-3.7%
Short-Term Treasury	0.9%
Mortgage Backed	4.4%
Inflation Protected (TIPS)	7.0%
Investment Grade Corp.	9.6%
Intermediate Corp. Bonds	12.2%
High Yield Bonds	23.5%

High yield and corporate bonds have recovered part of those losses this year and have generated large total returns YTD ranging from 9.6% to 23.5%. Similarly, the flight to Treasury securities was so extreme in 2008 as the benchmark ten-year Treasury yield approached 2% and t-Bills zero it was inevitable that Treasury prices would lose some ground during 2009 as the economy recovered and investor confidence improved.

## **ROTH IRA CONVERSION IN 2010**

A Roth IRA (Roth) is a modified IRA in which both earnings and withdrawals are free of Federal and usually state tax. These are the primary benefits of the Roth: avoiding future taxes and allowing the account to grow without mandatory withdrawals. In a traditional IRA (IRA) only earnings are tax free and taxable withdrawals (RMD's) are mandatory. Unlike an IRA or retirement account, a Roth may only be funded with after-tax income so an investor must pay tax when choosing to convert all or part of an IRA to a Roth. This tax is the primary "cost" of a Roth. Through 2009 Roth conversions were only available to taxpayers with less than \$100,000 of modified adjusted gross income (MAGI); but, this requirement is eliminated in 2010. Roth conversions will only make sense when taxpayers have cash outside of retirement accounts that can be used to pay the conversion tax without creating a further tax burden.

Since the \$100,000 income limit for Roth Conversions will be eliminated in 2010, many commentators in the media are trumpeting the benefits of a 2010 Roth IRA Conversion for wealthy taxpayers. Roth Conversions are complex and require careful analysis or significant mistakes could be made resulting in a needlessly large tax burden in the 2010 to 2012 period. We have found that the best way to understand a Roth conversion is with discount cash flow analysis which compares the net present value (cost) of taxes paid on a Roth conversion during the 2010 to 2012 period with taxes paid on mandatory IRA distributions (RMD's) over a projected lifetime. The assumptions used for tax rates, time horizons and rates of return can greatly affect the

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results so remember to test several scenarios. For Federal Tax purposes, the tax on a 2010 Roth Conversion can be deferred evenly to 2011 and 2012, which must also be factored into any analysis.

A general rule of thumb is that Roth Conversions will make more sense when future tax brackets are likely to be higher than ones' current tax bracket. Higher rates of rate of return and longer time horizons will also tend to favor a Roth conversion because the Roth account benefits from tax free growth and compounding.

Roth conversions work well under the following scenarios:

1. A client has a tax credit or net operating loss or charitable deduction carry forward which keeps them in a low bracket at the time of the Roth conversion.
2. There is a high probability that an investor or beneficiary will be in a significantly higher tax bracket in the future. Note that the top two marginal Federal brackets are due to rise to 36.0% and 39.6% in 2011.
3. The investor's highest priority is passing assets in a tax free manner to children and grandchildren.
4. In many conversion examples that we review it can make sense to convert an amount that still leaves the taxpayer in the same marginal bracket. For example, an investor with \$137,500 of income can convert \$70,000 a year (a "partial conversion") from a traditional IRA to a Roth

without leaving the 28% tax bracket.

A few features to keep in mind re: Roth IRA's:

1. There are no required minimum distributions (RMD) from a Roth IRA, so a Roth can be an ideal vehicle in which to leave assets to heirs.
2. Roth conversions from non deductible IRA's are tax free up to the amount of your original basis.
3. You can reverse an ill-fated Roth conversion (e.g. when the converted value drops sharply) up until October 15<sup>th</sup> of the year following the conversion.
4. Paying income tax prior to estate tax allows greater wealth to be passed to children (i.e. the methodology of a Roth conversion).
5. Often tax rates will rise when a first spouse dies and the "Married Filing Jointly" IRS bracket and deductions are no longer available; a Roth conversion can partially offset this.
6. The Roth conversion could bump you into a higher tax bracket and make you ineligible for certain tax breaks.
7. Rolling a qualified employer plan like a 401K or 403B to a Roth gives up creditor protection.

Please call at any time with questions.

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## TAX CHANGES FOR 2010

At this time of year we like to update clients on the current Federal tax brackets as well as retirement plan and gifting contribution limits. The IRS has not published all contribution limits but most commentators anticipated that declining inflation as measured by CPI-U compared to last year would reduce several contribution levels from 2009 as shown below. Plan and IRA “catch up” contributions are only for investors over age 50.

Thank you for your continued confidence and trust.

Yolles-Samrah Wealth Management

2010 Marginal Tax Brackets	
Tax Bracket	Filing Jointly (AGI)
10%	Up to \$16,750
15%	Up to \$68,000
25%	Up to \$137,300
28%	Up to \$209,250
33%	Up to \$373,650
35%	\$373,650+

Retirement Contribution and Gifting Limits 2010		
Plan Type	2009 Contribution Limit (\$)	2010 Contribution Limit (\$) (E)
401K, 403B, 457	16,500	16,000
"Catch Up"	5,500	5,000
IRA	5,000	5,000
"Catch Up"	1,000	1,000
Defined Contribution, SEP	49,000	48,000
Simple IRA	11,500	11,000
"Catch Up"	2,500	2,000
Gifting Limits per person	13,000	13,000