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Do Roth IRA Conversion Rule Changes Help You?

Why would you volunteer to pay income tax next year by converting a traditional IRA to a Roth IRA? If you leave things alone, you won't owe any current tax on the assets in your account, regardless of their investment performance. But the promise of a future tax payoff—combined with the prevailing economic conditions—may warrant this unusual approach. And thanks to a recent tax law change, a conversion to a Roth in 2010 will be a possibility for all investors, regardless of income.

With a traditional IRA, contributions may be tax deductible, but the amount you deduct and subsequent earnings will be fully taxed as income when withdrawn during retirement. (The same rules apply to IRAs holding assets rolled over from traditional 401(k)s or other employer-sponsored plans.) And you generally must begin taking those taxable distributions during the year after the year in which you turn age 70½.

In contrast, contributions to a Roth IRA are never deductible, but qualified distributions from a Roth that has been established for at least five years are completely tax free. And because the government won't benefit when you take distributions, it doesn't require you to take them.

Until now, the catch has been that high-income individuals can't contribute to a Roth IRA, and converting a traditional IRA to a Roth hasn't been allowed if your adjusted gross income exceeds $100,000. The latter rule changes in 2010, when the income cap for conversions is eliminated. And though a conversion to a Roth requires you to pay income tax on the amount you convert, if you make the conversion in 2010, you're allowed to spread out your tax payment over 2011 and 2012.

Choosing between saving for retirement with a traditional IRA or a Roth is in part a question of whether it's better to pay the IRS sooner or later. Being taxed on current contributions to a Roth IRA or for a conversion from a traditional IRA takes money out of your pocket now, but you may do better later, either enjoying tax-free distributions or passing along the account to your heirs, whose withdrawals also won't be taxed. But the law permitting anyone to convert to a Roth, coupled with the bear market's depressed asset values, adds interesting twists to this debate. Consider these four reasons it may pay to convert.

1. You'll pay less to convert an IRA whose value has plummeted. Rare is the investor who hasn't seen retirement account values fall by at least 25% during the bear market. As painful as that has been, however, it can be an advantage if you choose to convert to a Roth IRA in 2010. You'll be taxed on the value of the account at the time of the conversion, regardless of what it may have been worth a few years earlier. Suppose the assets in your

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Keeping Guard Against Inflation

If you don't think inflation could rear its ugly head again, you could be fooling yourself. Currently, the Obama administration is most worried about price deflation. But recent events could change that outlook.

For starters, the federal government is spending money at an unprecedented clip. It has approved a $787 billion stimulus program, a budget of $4 trillion (up from $3 trillion the prior year), and hundreds of billions more in rescue packages. Also, short-term interest rates, guided by the Federal Reserve, have hit rock-bottom, and rates are quite low in other countries, too.

All of this is kindling waiting for a spark. Once ignited, growth and inflation could come roaring back to life.

For that reason, it's smart to allocate a portion of your fixed-income investments to Treasury inflation-protected securities (TIPS). These bonds are backed by the U.S. government, and have built-in protection that boosts their value when inflation rises. Since inflation might not return for a few years, and TIPs currently have extremely low nominal yields, averaging into these investments over time could be a better strategy than investing a large sum all at once.

Another inflation-hedging strategy is to invest in commodities. When growth resumes, demand for oil, copper, and other commodities will rise, increasing their prices. But given the volatility of commodities, it's generally recommended that you keep no more than 5% to 10% of your portfolio in this asset class.

Four Steps *Not* To Take Right Now

As the tough economic times push on and stock prices fluctuate, it's hard to know what moves to make as an investor. Though the panic you probably felt during the early months of the bear market may have ebbed, your account balances still aren't fun to look at, and the direction of the market is anything but certain. Was the spring-summer market rally the first leg of a new long-term bull market? Or will unemployment, lackluster corporate profits, and a shift from consumer spending to saving post-pone the recovery and keep share prices volatile?

Definitive answers may be a long time in coming. But in the meantime, there's no reason to abandon the fundamental investing principles that have worked for you in the past. Here are four moves *not* to make now.

1. Keep your money idle. It's tempting to sit on the sidelines while the markets sort themselves out. But there are two problems with that approach. The first is that if you're going to reach your retirement goals, you'll need growth in your portfolio, and that means putting your money to work in suitable investments. The second is that if your plan is to sit out until markets improve, you'll inevitably miss much of what the market provides. The best time to buy is when the market is down, not when you feel comfortable, and trying to time your entry and exit into the market almost never works.

2. Chase the golden goose. Trying to get well in a hurry by jumping on the bandwagon for high-flying stocks or high-yielding bonds is another common investing mistake. The best time to invest in a particular sector or category is before a market run-up, not after. You'll probably be too late to the party if you invest heavily when substantial gains have already been realized, and you may be left holding overvalued investments vulnerable to sharp declines, especially while the markets remain volatile.

3. Rely too much on "safe" investments. Diversifying your portfolio with reasonable allocations to low-risk, low-return investments such as bonds and money markets is smart, but veering too far in that direction can be just as damaging to your long-term prospects as chasing hot stocks or trying to time the market. "Safe" investments bring their own risks, including a loss of value when interest rates rise and inflation picks up.

4. Stop saving for retirement. When times are tough, paying bills may have to take precedence over saving. But your future needs are also crucial, and continuing to contribute to your 401(k) or other retirement plan—even, or especially, if its value has plummeted—is the only way to ensure that you'll reach your long-term goals. These turbulent times too shall pass, and it only makes sense to keep working toward your ultimate objectives. In fact, cost averaging into your 401(k) enhances returns when the market drops—a reward for continuing to save. ●

Using Your IRA To Pay Education Expenses

IRAs, obviously, are for retirement. And except in very special circumstances—say, if you've come into a major inheritance—the money in your retirement account ought to be off limits for any other purpose. But if your financial plan shows you really won't need your IRA for retirement, there's another way you could use it, even if you have not yet passed the age-59½ threshold to make penalty-free withdrawals. You could pull out cash to pay for your children's education.

The basic rule is pretty simple. Though you'd ordinarily incur a 10% early withdrawal penalty for taking a distribution from your IRA before age 59½, that doesn't apply if the money goes to pay qualified education expenses for you, your spouse, or any child or grandchild of you or your spouse. And for these purposes, "child" is defined rather broadly. A stepchild, a legally adopted son or daughter, or even a foster child (subject to some conditions) can qualify.

Almost any post-secondary educational expenses count for this preferential treatment. The money for tuition, fees, and books can come out of your IRA as long as it goes to an accredited college, junior college, or graduate or professional school. The school can be public or private, nonprofit or for profit. If the student is attending at least half time, room and board counts, too.

Though there's no preordained ceiling on the educational costs an IRA withdrawal can cover, you can't take out more than the total qualified expenses incurred during a particular tax year. You'll also have to subtract the amount of any other tax-advantaged distributions or aid applied to school costs. This may include tax-free Coverdell distributions, the non-taxable portion of scholarships or fellowships, Pell grants, or tax-free assistance from your employer, among

Despite Crisis, The World Is Getting Better

If you're looking to the world's top investors for advice on which way to turn in today's unnerving environment, you may wind up more confused than ever. Two brilliant investment managers, Barton Biggs and Jeremy Grantham, agree on the short-term outlook but part ways when it comes to the long view.

In separate interviews, both Biggs and Grantham recently predicted the stock market rally will continue in the short term, fueled by government stimulus money and growth in emerging markets. However, Grantham predicted the current rally will prove to be fueled by "false hope" and will be followed by seven "lean years" in the markets as a result of "major systemic problems in the global financial system."

Biggs predicted the Standard & Poor's 500 stock index would hit 1,050 and economic expansion in emerging countries would then continue to fuel market growth, albeit within a potentially limited trading range.

Grantham is the founder of GMO, a Boston investment firm. Biggs is the co-founder of Traxis Partners, a hedge fund in New York City, and former chief global strategist for Morgan Stanley. Both are legendary Wall Street strategists.

So whose advice should you take? They cannot both be right about the future.

Biggs and Grantham agree there are two primary factors to consider—world government stimulus efforts and emerging markets. Speaking at the 2009 Morningstar Investment Conference in Chicago, Grantham said the globally coordinated government stimulus effort would provide the hope necessary to push the current market rally further upward, and he predicted the S&P 500 Index would reach 1,100. However, this rally has "nothing to do with reality," he said, and eventually will fade as the effects of stimulus money play out and the global economy remains stuck with the same structural problems that caused the economic crisis. He discussed the massive fiscal imbalance among nations, with the United States, among others, needing to rein in spending while other countries such as Japan and Germany should be spending more.

Investors will pour money into developing countries in the near term because they still boast healthy growth rates, and that will fuel a rally. But Grantham warned that emerging markets will form the next big investment bubble, and when it bursts it will set the stage for seven years of worldwide market stagnation.

His advice? Avoid trying to make up for recent losses by pouring everything into the current rally. Instead, decide how much money you want to invest in the stock market and divide it by 15, then invest that fraction each month for 15 months, to better allocate your resources.

In contrast, in a Bloomberg TV interview, Biggs predicted the current market rally will have legs. "There is a huge amount of very aggressive money on the sidelines that is experiencing great pain," he said. "We could have a 'melt-up' buying panic."

Biggs characterized the current run-up as "a relief rally that the world's not going down the drain." He said he believes the global stimulus measures are working, both fiscally and in regards to monetary policy, and will have a positive effect over the long term. "There have not only been improvements in sentiment; now there are some real signs that growth is actually resuming in certain economies," he said. "There are real signs of positive growth, albeit from very depressed levels, in Korea and Japan."

Growth in the developed world will remain slower going forward, Biggs said, perhaps at a 2% annual rate rather than 3%. But the positive side of that is a lack of any serious inflation threat. Noting that emerging markets such as China are likely to grow significantly faster, Biggs said investing in emerging markets will fuel stock market growth for years to come. "I think we're going to be in a world very similar to the period from 1974 to 1982, where the market was in a big broad trading range," he said. "I want to be there, but we're going to have to be more market timers."

As you ponder which team to join, remember that while the 2008 market meltdown has shaken the investment world to its core, the smart money has always gone with the optimistic view over the long term, while staying diversified and rebalancing as a specific sector disproportionately advances or declines. The very underpinning of investment is a belief in the future, a faith in progress. Bad times come along periodically, but the people of the world react by using innovation and creativity to move forward and create a better world. ●

other things. But the amount you can withdraw without penalty won't be reduced by payments from other sources, including your income, loans, gifts, or withdrawals from 529 college savings accounts.

The only real downside to using IRA money—again, assuming you won't need it for retirement—is that withdrawals for education from a traditional IRA will be taxed as income. If the withdrawal comes from a Roth IRA funded with after-tax dollars, only the portion deemed to come from account earnings will be taxed. After the Roth has been in existence for five years, distributions are completely tax-free if made after age 59½.

Moreover, any tax you pay on an IRA withdrawal poses another problem. Your penalty-free distribution is capped by the amount of qualified educational expenses less any adjustments for tax-free awards. You can't withdraw enough to generate that total amount after taxes; you can take only the amount itself. So, for example, if the expenses amount to $50,000 and you pay total federal and state taxes of 40%, that extra $20,000 will have to come from outside the IRA. If you take the entire $70,000 from your IRA, the 10% penalty applies to the $20,000, increasing your tax bill by $2,000.

Just be sure you don't need the money to fund your retirement, and have that all figured out first in a detailed financial plan. ●

Roth IRA Conversion

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IRA were worth $500,000 a year ago, but in 2010, they are worth only $400,000. At the top current income tax rate of 35%, that saves you $35,000.

2. You'll avoid a higher tax bill later if rates rise. With individual tax rates at near-record lows and tax revenue falling far short of federal budget commitments, tax rates are likely to go up in the near future. It may be better to take your lumps under current tax law—even if all or part of the conversion is taxed at the top rate of 35%—than to risk losing much more of your investment to the IRS later.

3. Converting to a Roth IRA gives you maximum flexibility on distributions. There's not much give in the rules on withdrawals from traditional IRAs and 401(k)s. Beginning the year after the year you reach 70½, you'll face minimum annual distributions designed to use up the account during your expected life span—and you'll pay a 50% penalty on any shortfall from the required amount. With a Roth, you can take as large or small a distribution as you choose each year, and you have the option of leaving the account intact to provide tax-free income to your heirs.

4. A partial conversion to a Roth lets you customize your tax liability and benefits. A Roth IRA conversion needn't be an all-or-nothing proposition. You can convert as much or as little as you want each year (although the option of stretching out tax payments applies only to conversions in 2010). Making a partial conversion lets you limit current payments to the IRS while also providing some tax-free income during retirement.

We can help you decide whether a conversion makes sense in terms of your unique situation and overall financial goals. ●

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Horace C. Gordon, IV, CPA/PFS, CFP®
Gordon & Associates Financial Advisors, Inc.
2907 W. Bay to Bay Blvd, Suite 104B
Tampa, FL 33629
www.gafainc.com

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