

December 10, 2009

Roth Conversions

Looking Back One Year – With Gratitude

A year ago, we were in the midst of rebalancing all our clients' portfolios in an unprecedented mobilization to respond to market conditions. We believed then that clients who maintained their investment policies through the crisis would be rewarded in two ways. First, they would not be “whipsawed” by getting out of the markets before some sanity was regained. Second, by making tactical asset allocation changes, client portfolios could benefit from opportunities created by panicked sellers. These efforts were overwhelmingly successful. Better than 95% of our clients adhered to their policies, and their portfolios have recovered better than the market indexes because of the tactical changes we made last December and manager skill since then. We're grateful for our partnership with you and for your trust.

Roth IRA Conversions

If you haven't already, you'll probably hear soon through the media about a “new opportunity” to convert traditional IRAs to Roth IRAs because of a special rule in the tax laws that will apply starting in 2010. In your annual review and report, we'll discuss whether you qualify for a Roth contribution and whether you should consider a Roth IRA conversion. But in the interest of planting the seed, we describe below a few key points.

As we've discussed before in your annual financial report, Roth IRAs are wonderful to have (but expensive to get—keep reading!) because, unlike a traditional IRA, qualified withdrawals from a Roth IRA are tax-free and the government doesn't require the owner to make taxable distributions during the owner's lifetime. In particular, the ability of an inheritor of a Roth to withdraw from the account without paying income taxes make Roth IRAs superior to traditional IRAs as an estate-planning device.

While we love Roth IRAs, Congress has limited the ability of income earners to make contributions by disqualifying families with income over \$176,000. Also, because contributions to traditional IRAs are deductible, while those to Roth IRAs are not, the traditional IRA is often the better choice for most wage earners.

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Roth IRAs can be created both with annual contributions or through a conversion process that results in immediate income taxes. What's different in 2010 is that Congress will allow families with income over \$100,000 to convert IRAs, which wasn't the case in 2009 and before.

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For our clients with income under \$100,000, it's been our routine practice to convert IRAs to Roth IRAs whenever it makes sense.

For someone who is working, converting usually doesn't make sense because the person will likely have a lower average tax rate in retirement (when he would make withdrawals from the traditional IRA) than the marginal income taxes he would pay now on the amount converted to a Roth. Often, the candidate for conversion is a retiree with large tax-deferred accounts and very low taxable income.

Despite Wall Street cheerleading about the benefits of conversion (which only faintly disguises broker interest in winning new accounts!), we think the decision to convert a traditional IRA to a Roth is often quite complex, involving both science and a crystal ball. Behind the seemingly simple calculus lie several considerations and assumptions, including current taxes, possible future tax rates, future investment performance, your level of wealth, estate-planning goals and how much is invested in other types of accounts and assets. Because tax rates, especially for higher income earners, are generally expected to increase in the future, incremental conversions from traditional to Roth IRAs may make more sense than ever before if the conversion can be done with modest taxation. In other words, a partial Roth IRA conversion might be advisable as a form of hedge against higher taxes in the future.

We look forward to talking with you about this and other issues that affect your finances. Long-term financial success depends on more than good investment decisions; good future planning, budgeting, risk and tax management are important factors, too.

We of course welcome your calls. And best wishes to you and your family for the Holidays!