

Winter 2009-2010

# NAVIGATOR

THE NEWSLETTER FOR THE CLIENTS OF TGS FINANCIAL ADVISORS



## GOODBYE TO ALL THAT<sup>1</sup>

by James S. Hemphill CFP®, *Managing Director*

Is anyone else out there happy to see the end of this past decade?

Our initial complaint about this first decade of the new century is simply what to call it. The Two-Thousands? The Naughty Oughts? The Awful Oh-Ohs? The Lost Decade?

Whatever we call it, it was the worst decade in modern history for U.S. common stocks. The S&P 500 Stock Index declined 0.9% per year over the ten years, just on the wrong side of zero. Saying the market went nowhere is accurate, but understates the psychological trauma of two brutal bear markets in the past ten years.

The decade past also saw the end of a generation-long bipartisan consensus in favor of sound money, low-to-moderate tax rates and limited deficits that lasted from midway through Ronald Reagan's presidential term until the end of Bill Clinton's. Under President George Bush and the Republican Congress, we saw expanded entitlements (Medicare drug benefit), growing acceptance of budget deficits (Dick Cheney: "Deficits don't matter") and ultimately massive Keynesian fiscal and monetary stimulus.

Many of the policies we disliked when implemented by Bush and a Republican Congress have continued and accelerated under Obama and the Democrats. With budget

deficits projected to exceed 10% of GDP for years to come, Americans across much of the political spectrum are reacting with emotions ranging from concern through horror to intemperate rage. The anger is directed at both major parties — for the first time, registered Independents outnumber either Democrats or Republicans.

We wish the powers-that-be in Washington would more seriously engage the issue of *structural* reform of the financial sector, as opposed to simply adding a new tax and a layer or two of bureaucracy. The central problem in our incestuous political/financial culture is moral hazard — the ability of some big players to take oversize risks and make oversize profits, with the assumption that the U.S. taxpayer will pay the bill if their bets go south.

We'd like to see reform of Freddie Mac and Fannie Mae (repeal the Community Reinvestment Act of 1992), stricter regulation of derivatives (change The Commodities Modernization Act of 2000), a return of Glass Steagall's separation of commercial and investment banking, and the break up of some big, dumb banks.

We can dream<sup>2</sup>.

<sup>1</sup>*Goodbye to All That* was the title of English poet Robert Graves' book about his experiences in the Great War.

<sup>2</sup>Our enthusiasm for real financial reform does not extend to recent attacks on the Federal Reserve and Chairman Ben Bernanke. We think recent proposals that Congress (Congress!) should audit the Fed, which are being pushed by a peculiar coalition of far-left and far-right Congresspersons, are the stupidest idea since...actually, we can't think of a stupider idea.

(continued on next page)

If we consider modern American history, we see periods of consensus with dispute at the margins, alternating with periods of fundamental disagreement ending in a decisive mandate for one political philosophy over another. Right now we are in one of the periods of dispute, with a new consensus nowhere in sight. What happens next?

No bets here. One possibility is a chaotic seesaw battle between liberals who wish to expand entitlements but are frustrated by the unwillingness of the citizenry to finance them; and conservatives pledging to reduce the size of government but finding middle class voters firmly attached to their existing entitlements. The result could be alternating and incompatible tax, regulatory and monetary regimes, with periods of government expansion followed by periods of retrenchment, but without any ultimate resolution of the tension between government's commitments and its financial resources. That way lies Argentina.

In the face of this much uncertainty, and with the U.S. political system more divided and contentious than at any time since the 1980s, what should a prudent investor do? Since we can't control the political process, we offer the following strategies for dealing with uncertain markets:

**Detach your investment strategy from your political opinions.** The worst investment decisions we've seen in decades were made during the market meltdown from September 2008 to March 2009, by political conservatives confusing Obama's legislative agenda with the end of the capitalist system. Just for the record, I'm conservative and oppose much of Obama's agenda. I check those opinions at the door each morning, before I make a single investment decision.

**Go global.** On the one hand, we know that the U.S. economy has been for more than 200 years the greatest wealth-creating engine the world has ever known. On the other hand, we worry that current trends and policies may reduce the long-term

growth potential of the U.S. economy. Diversifying globally gives us access to a broader range of investment opportunities, and lets us place money in countries whose long-term policies are favorable to the creation and preservation of wealth.

**Recognize the relationship between fear, disorder and opportunity.** Markets do best during periods of economic stability and political consensus, but opportunities are greatest during periods of upheaval and uncertainty.

**Follow prices, not trends.** During long bull markets, pure buy-and-hold can work very well. During periods of transition before the emergence of a new consensus, markets are more volatile and trends can reverse quickly. We have powerful tools to help us recognize both undervalued and overvalued assets, and we stand ready to act decisively to capture opportunity and manage risk.

**Delegate investment decision-making.** Research in behavioral economics shows that most intelligent and successful people are lousy investors, and one recent study actually appears to show that investment success is more a function of genetics than experience or training. Hire proven experts. We're available.

**Take control of your own spending and saving.** The most important variable in determining whether an investor will achieve financial independence is not investment performance, but saving and spending behavior. Save enough and you will be able to retire with confidence, *especially* if markets decline. Spend responsibly in retirement and you won't run out of money. We can provide excellent measures of both saving and spending.

Here at TGS, we are guardedly optimistic about the coming decade. At least we know what to call it. (We've settled on The Teens.) We expect a bumpy ride ahead, but we remain confident that good investment decisions will lead to favorable outcomes, regardless of the direction of the markets.

## Financial Planning: Traditional and Roth IRAs

# TO CONVERT OR NOT TO CONVERT?

by Halsey Mercer Bittel, *Financial Planning Associate*

The New Year marks the permanent repeal of the \$100,000 income test for Roth IRA conversions. Regardless of income, everyone is eligible to convert existing Traditional IRA assets to the Roth IRA, which features tax-free, post-59 ½ distributions with no Required Minimum Distributions (RMDs) for their lifetime. The cost? Ordinary income tax on the amount converted in 2010 spread over two years, thanks to the “income-splitting” rule.

Though initially appealing, a Roth conversion may not be justified in all cases. Several characteristics may favor a conversion for certain investors; however be wary of the many factors that could potentially render a conversion more costly than beneficial.

	Traditional IRA	Roth IRA
Growth	<i>Tax-deferred growth</i>	<i>Tax-free growth<sup>1</sup></i>
Mandatory Distributions	<i>RMDs at age 70 1/2</i>	<i>No RMDs</i>
Taxation Distributions	<i>Ordinary income</i>	<i>Tax free</i>

<sup>1</sup>Growth tax-free if you obey the five-year rule AND begin distributions after age 59 1/2. There are exceptions for early withdrawal due to disability; death; first-time homebuyer.

### Advantages of Conversion

The up-front tax hit will most efficiently be recouped when the period during which Roth assets can grow is maximized. Thus, investors able to delay or avoid mandatory distributions are more likely to gain from converting.

For estate planning considerations, a Roth is compelling for those investors planning on passing significant IRA assets on to heirs, who will benefit from tax-free withdrawals stretched over the beneficiaries’ lifetimes. Smaller conversions lessen

the tax bite and the risk of being bumped into a higher tax bracket. A partial conversion could be viewed as a hedge against future adverse tax changes, as your assets are held in accounts with diverse tax treatment.

### Potential Pitfalls

The decision to convert turns a deeper shade of gray once tax risk is considered. The issue boils down to whether Roth assets’ tax-free distributions in the future outweigh the current tax liability on conversions. If tax rates are lower today than future years, pay today and convert; if tax rates are higher today, stay put in a traditional IRA and pay tomorrow.

Ultimately, all cost-benefit analysis must pay particular attention to increased marginal income tax rates and surcharges. Self-employed taxpayers, included LLC or Sub-S business owners, should also factor in self-employment and health care taxes that could be considerably diminished post-retirement, but may substantially increase over the next few years.

Many observers anticipate future tax increases as a necessary consequence of current spending policies, not to mention growing unfunded entitlement liabilities. Nevertheless, how and when this burden manifests itself in future tax policy is up for debate. One must remember that all considerations of future tax rates are merely forecasts. The solution for some may lie with conventional wisdom: *never pay an avoidable tax today for a potential tax break tomorrow.*

The decision to make a Roth conversion should involve a discussion of your long-term goals, current income, retirement expectations, and estate planning considerations. As always, we are available to help you determine whether a Roth conversion is appropriate.

# A PRESCRIPTION FOR RETIREMENT

by David A. Burd CFP®, *Managing Director*

I work with a number of physicians and over time I have learned that many of them struggle with the balance between time and money, where stress and burnout are constant companions. Poor retirement planning only adds to their retirement “health” problems.

Here are some thoughts from a recent presentation we made to a local cardiology group. We try to educate our clients on the alternatives available, which we believe should reduce stress as it relates to pre-retirement planning and retirement.

## **Americans are working longer**

According to Barron’s, workers over 55 comprise the fastest growing labor segment (a trend that began in the early 1990s), and is projected to grow more than five times faster than the overall labor force according to the Bureau of Labor Statistics. While not all people work in retirement by choice, our experience is that many of our clients do just that. Working past your planned retirement date, even if it is part-time, can meaningfully improve your financial security. The impact is obvious when we examine various retirement simulations for clients.

## **Extra income now, success later**

You may have heard that you should only spend a certain percentage of your assets annually if you want your savings to last. We often target 4% to 5% in our analysis as a starting point, but the rate you can prudently spend will vary depending on the specifics of your situation.

Here’s something to consider. If we assume that you can annually spend 5% of your capital (\$50,000 for every \$1,000,000 you have saved), then every additional \$50,000 earned is the earnings equivalent of having an additional \$1,000,000 in your portfolio. The moral

of this story? *Part-time work can have a significant impact on your success in retirement.*

## **Curtailing pre-retirement stress**

I’ve found that the period leading to one’s retirement is often very stressful, as individuals and couples struggle with difficult questions, such as:

- Will we outlive our money?
- What if one of us gets sick?
- Can we afford this house (or, two or three homes?)
- How should our investment strategy change once we retire?

To alleviate stress and develop a successful plan, you need to understand:

- Where you are. (*How much is your total portfolio worth?*)
- Where you are going. (*How much money do you need to accumulate through savings and investing?*)
- What you will do when you get there. (*What does your ideal retirement look like?*)

Our job is to help you identify financially rational and measurable goals, and track your progress towards those goals over time. We have many resources to help you with both the initial planning and long-term tracking. One of the most important resources we provide is experience. While you will experience the retirement transition only once, our firm’s advisors have experienced hundreds of individual retirement cases through our clients. We understand the moving parts of successful retirement.

There are no simple answers, which make the important decisions that much more difficult. Instead of an one-off diagnosis, we approach retirement as a continual process of monitoring, evaluation, and adjustment.

# 2010 TAX UPDATES *[ you need to know about ]*

by Vincent R. Barbera CFP®, *Financial Advisor*

Below are some key tax points that you should be aware of for 2010.

## **Roth IRA Conversion**

As Halsey discussed in detail earlier, the \$100,000 Modified Adjusted Gross Income (MAGI) limitation to convert a Traditional IRA to a Roth IRA is waived in 2010. Keep in mind that for conversions in 2010, taxpayers can spread the tax due over two years. Half the tax will be due in 2011, and the remaining half will be payable in 2012. Removing the limit on conversions effectively eliminates the income limit on contributions to Roth IRAs. A taxpayer with income too high to contribute to a Roth may be able to contribute to a non-deductible Traditional IRA (which does not have income limits for contributions) and immediately convert to a Roth.

## **Estate Tax Repealed**

The Federal estate tax is repealed for 2010 (and only 2010 for now). No estate tax means there is no limit to federal estate tax free wealth that can be passed to heirs upon death through the end of the year. In addition to the estate tax, the so-called generation-skipping transfer tax also disappears in 2010. That tax was imposed at 45% in 2009 on gifts to grandchildren. In 2011, the Federal estate exception drops to \$1 million. It is the stated intention of Senate Finance Committee Chairman Max Baucus to reinstate the tax, retroactively to January 1, 2010.

## **State and Local Sales Tax Deduction**

The opportunity for itemizers to choose to deduct their state sales tax payments *instead of* their state and local income taxes ended in 2009.

## **Educators' Deduction**

Teachers will no longer be allowed to deduct out of pocket expenses incurred for school supplies.

## **Capital Gains Tax Rates**

Favorable tax treatment of capital gains and qualifying dividends continues through 2010. For people in the 10% or 15% tax brackets, those tax rates remain at 0%. The 15% maximum tax rate on long-term capital gains and qualifying dividends (for taxpayers in higher brackets also remains the same). These rates are scheduled to increase in 2011.

## **Exemptions for the Alternative Minimum Tax (AMT)**

For 2010, the exemption levels drop to \$45,000 for married filing jointly, \$33,750 for singles and heads of household, and \$22,500 for married couples filing separately. In 2009, the AMT exemption was increased to \$70,950 if married filing jointly and \$46,700 for singles. (Congress might act in 2010 to extend the relief that was available last year.)

## **Credit for Energy-Saving Home Improvements**

The 30% tax credit on the cost of energy-saving home improvements reverts to 10% after 2010, and is capped at \$500. If you plan to replace your air-conditioner or furnace, make sure to do so this year to maximize the tax benefits.

## **Phase Outs**

For 2009, if your adjusted gross income exceeded \$166,800, your itemized deductions began to phase out. In 2010, there will be no phase out of itemized deductions or personal exemptions. This change greatly benefits high income earners.

## **Required Minimum Distributions (RMDs)**

Please remember that required minimum distributions from IRA accounts resume in 2010. The RMD is also effective for inherited IRAs.

## CLIENT SPOTLIGHT

Client Shelley Minion completed the Philadelphia Marathon in November 2009. Her first marathon, she finished it in 4 hours and 14 seconds, placing 14th in her age group.

An avid runner, Minion never imagined that she'd run a marathon. She initially registered with her sister-in-laws, both of whom dropped out early. Not knowing what to expect, she did everything possible to prepare for the 26.2 miler, including reading a dozen running books. After months of dedicated training and preparation, she ran the race on November 21<sup>th</sup>. She couldn't have been happier with the result. In her words, the process was, "An incredible challenge and a daunting – almost overwhelming goal. It ranks as one of the most satisfying and gratifying achievements of my life."

Minion sees more marathons in her future. We congratulate her on an inspiring achievement.

*If you have a success story that you'd like to share with us, we'd love to hear from you.*

## Quote of the Quarter

"Isn't it funny when you walk into a investment firm, and you see all of the financial advisors watching CNBC — that gives me the same feeling of confidence I would have if I walked into the Mayo Clinic or Sloan Kettering and all the medical doctors were watching General Hospital..."

*Anonymous comment from UBS Senior Portfolio Manager on Barry Ritholtz's blog, The Big Picture ([www.ritholtz.com/blog/](http://www.ritholtz.com/blog/))*

David Burd, Jim Hemphill and Vincent Barbera were each named among the Philadelphia area's *Best Wealth Managers* in 2009. The ranking was based on client satisfaction research (Five Star).

It appeared in the November issue of *Philadelphia Magazine*.

## TGS Financial Advisors' TEAM NEWS

Rainey Rylko is excited to announce that she will soon be assuming a role that she has always hoped to play – grandmother. Her daughter and son-in-law, Carrie and Jason Conwell, are expecting their first child, due in April.

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On October 3, 2009 David and Jim completed the MS 150 City to Shore Bike Tour. Together they raised over \$4,300 in support of the Multiple Sclerosis Society. The MS Society successfully exceeded their 2009 fundraising goal of \$5,150,000.

David completed the "scenic century," a 100-mile ride, in just under six and a half hours. Not bad for someone who has been around for over five decades!

Jim rode with his daughter, Katharine, age 11. For the first time, Katharine rode her own bike. They completed the 25-mile course and finished in less than two hours.

*Thank you for your support and generosity.*

**IMPROPER DISPOSAL OF AN OLD COMPUTER IS A SECURITY RISK AS WELL AS ENVIRONMENTAL NO-NO**

From March 1<sup>st</sup> through the 5<sup>th</sup> we invite clients to drop off their old computer(s) to be recycled. All computers will receive certified data destruction. For questions please feel free to contact us.

# TGS Questions and Client Answers

This quarter we turn the question-and-answer process upside down. On October 27<sup>th</sup> we held a *Client Advisory Board* meeting to help us understand how clients were feeling after the market's wild ride over the past year. We asked: *How has the game changed? What impact have these changes made in your own thinking, planning and practice? How did TGS perform during the downturn and recovery? What worked? What didn't work?*

Here's a summary of what we heard from a group of long-term clients.

There has been a general loss of confidence in both the financial markets and the political system. There is a sense that "the playing field is not level," and that the politically well-connected are reaping outsized awards.

Clients are reluctant to add debt and are decreasing discretionary spending. They are reconsidering risk tolerance and keeping higher than normal cash reserves just in case.

Younger clients are worried about retirement, for two reasons. First, they are unsure the markets will produce high enough returns to support portfolio growth. Second, they worry about whether their employers will make any contribution to their future wealth. (For example, one employee of a public company fears that his stock options will expire worthless, instead of providing the wealth he expects to help with college expenses and retirement.)

In terms of how TGS did, we received high marks for communication and leadership. Our key contributions were keeping clients invested and buying during the downturn. On the other hand, some clients noted that we failed to anticipate the crash, and that some specific investments did worse than the market on the way down.

## BOOK RECOMMENDATION

### *Brain Rules: 12 Principles for Surviving and Thriving at Work, Home, and School*

by John Medina | Reviewed by Shauna Mace

Weighing in around three pounds, the brain is the most powerful and yet mysterious organ in our bodies. Sadly, we live, learn and work in a world that is structured at odds with our brain's natural processes.

In [Brain Rules](#), molecular biologist John Medina presents the most recent research about how our brains function, in the form of twelve rules to help our brains work better in the modern world. Among the 12 rules that Medina unpacks through scientific fact, experiment and real-life stories are:

- Exercise boosts brain power
- Stressed brains don't learn the same way
- Vision trumps all other senses

[Brain Rules](#) is an important resource to help understand how to get the most out of ourselves as learners, workers and people. There are lessons to be learned by educators, employers and individuals that can improve our function, effectiveness and happiness.

*John Medina is a developmental molecular biologist and research consultant. He is an affiliate professor of Bioengineering at the University of Washington School of Medicine and is the Director for the Brain Center for Applied Learning Research.*

#### CORRECTION

Last quarter we incorrectly highlighted that the S&P 500 closed at 9606 on September 11, 2001 and again at 9606 on the same date in 2009. It was the Dow Jones Industrial Average that closed at 9606 twice, not the S&P 500. *Many thanks to the astute clients that noticed the error.*

# The Markets at a Glance (ending December 31, 2009)

INDEX	VALUE	ANNUALIZED RETURN		
		One Year	Five Year	Ten Year
Dow Jones Industrial Average	10428.05	22.7%	2.0%	1.3%
Standard & Poor's 500 Stock Index	1115.10	26.5%	0.4%	-1.0%
Morgan Stanley Europe, Australasia, and Far East Index (EAFE)	1580.77	31.8%	3.5%	1.2%
Barclays Capital Aggregate Bond Index	—	5.9%	5.0%	6.3%
Barclays Capital Municipal Bond Index	—	12.9%	4.3%	5.8%
Six Month Certificates of Deposit	—	0.8%	3.6%	3.3%
Inflation (Consumer Price Index)	—	2.7%	2.6%	2.5%

*Inclusion of these indices is for illustrative purposes only. Keep in mind that individuals cannot invest in any index, and index performance does not include transaction costs or other fees, which will effect actual investment performance. Individual investors' results may vary. Past performance does not guarantee future results.*

## MARKET COMMENTARY

For the year ending December 31, 2009, the S&P 500 showed a positive return of 26.5%, but that simple number obscures the roller-coaster ride that produced it. From the market high in October of 2007 to the final bear-market low on March 9<sup>th</sup>, the S&P 500 declined more than 56%. And from March 9 through year-end 2009, the market advanced almost 65%, one of the most explosive rallies in a generation.

Will the rally continue? Is this the start of a new secular bull market, one that may last for years and see the market reach new highs? Or is this a bull trap in the middle of a secular bear market, one that started in 2000 and still has years to run?

We don't answer market timing questions. We've never seen anybody who could predict the market over an entire cycle with enough accuracy to add consistent value. Instead of

worrying about the market's future direction, either short- or long-term, we pay close attention to the relative value of different asset classes. During the market collapse, we had the opportunity to shift funds from bonds to stocks at exceptional relative prices. That decision to over-weight stocks has been very profitable during the recent rally.

Today, after the explosive rally, we are back to a more cautious stance. We see few significant opportunities based on relative valuations. Stocks are no longer dirt-cheap, and quality bonds are expensive. It is important to stay diversified in order to limit downside volatility to an acceptable level, and to remain flexible in order to take advantage of pricing anomalies caused by excessive fear or greed.

*Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from TGS Financial Advisors. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.*

*Please remember to contact TGS Financial Advisors if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Please also advise us if you would like to impose, add or modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request. You should discuss any tax or legal matters with the appropriate professional.*