Lowly Analyst Newsletter

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The Economy and the Markets

For the long-term investor this was a good time to take a vacation. Keep your asset allocation intact, including money market funds. Sell any floating rate funds and invest proceeds in money market funds. You should get over 5% in these funds.

We must look at the recent decline in perspective. The S&P fell about 5% compared to 20% in 1998. The difference between treasury yields and 30 year fixed mortgage rates (called the spread of mortgage rates) increased to 1.9% compared to 2.3% in 1998. The spread between treasuries and Baa-rated corporate bonds increased to1.9% compared to 3.7% in 1998. Ten- year treasury yield increased to 5.1% compared to 5.6% in 1998. Emerging market bond spreads increased to 2% compared to 16% in 1998.

Despite the scary headlines, the global and US economies remain strong because of heavy demand from abroad. Our infrastructure, best in the world, remains intact, turbulence but no crisis.

Asset Classes: For the 6 months, large growth up 7%, mid growth 5%, small growth 4%, large value 2%, mid value -2%, micro -3%, small value -4%.

Sectors: For the last 6 months, oil & equipment up 33%, oil service 38%, energy 23%, steel 30%, internet architecture 27%,intrn basic materials 20%, natural resources 19%, US aerospace 18%, wireless 18%, environmental service 15%, clean energy 15%, water resources 13%, global telecom 13%, High tech 13%, global Industrials12%, semiconductors 11%, networking 8%, commodities 9%, gold 2%,

Foreign Investing: For the past 6 months, China up 52%, South Korea 31%, BRIC(Brazil, Russia, India, China) 35%, Brazil 34%, Latin America 27%, Emerging Markets 24%, Hong Kong 17%, Canada 17%, Germany 17%, Mexico 16%, Taiwan 14%, Pacific-J 14%, Australia 14%, Singapore 14%, Netherlands 13%, Europe 11%, Malaysia 10%, Sweden 10%, France 7%, Spain 7%, S. Africa 8%, United Kingdom 6%, Russia 6%, US 4%.

IRA Considerations

1. IRA Conversions to Roth IRA Summary

For individuals who have young or low tax individual heirs it does generally not pay to convert.

IRA holder at death have usually both IRA and taxable assets from the retirement plan. Roth converters only have all retirement assets in the Roth. Where the assets are held makes a huge difference to heirs. In the simplest case the after tax assets are the same for the IRA holder and Roth holder. But that assumes that taxes do not change.

Income taxes will probably increase for high income individuals. Current proposals define high income as Gross Adjusted Incomes greater than $200,000 for couples. For very low income individuals taxes may even decrease. I assume that taxes will increase. That gives the Roth an advantage. If you are currently in a very low tax bracket you should seriously consider converting.

But taxes do not stop at the death of the owner. Heirs of both an IRA and a Roth must make withdrawals. Heirs that are persons, as opposed to trusts or institutions, can make withdraws over their lifetime at their tax rate. If young, low tax individuals inherit they could have a very low tax rate. That gives the IRA an advantage since the Roth paid taxes at the owners probably high tax rate.

There is another tax to consider, the Estate Tax.

Estate Taxes could change. I assume there will be no estate taxes on estates less then $3,000,000 per individual. If assets are equally divided than a couple could shelter $6,000,000. For most individuals estate taxes are not a factor. Federal and State limits differ.

You see that to convert or not to convert is a difficult decision. The decision has to be made on an individual basis. Since many of the factors are not known it is best to use probability distribution. If you want me to assist you call.

2. Example of IRA vs. Roth IRA, Simplest Case

We will illustrate the effect of the key factors in the conversion decision by means of examples. All data is in real $, after inflation, in terms of purchasing power. What matters is not inflation but the annual rate of change in your cash flow needs. The cash flow needs rise as you age. With age your medical expenses and living expenses increase because you can do less for yourself and need more help with maintenance of your house and daily living. The tax rate is the average tax rate, total tax payments divided by Adjusted Gross Income.

IRA	$1,000,000
Age	70 Years
Real Return	6%
Life Expectancy	20 years
Average Income Tax Rate	40%
Cash Flow Needs	$60,000 per year

Owner pay taxes with funds outside the IRA without payment of capital gains taxes.

For the IRA initially returns and withdrawals are the same and assets remain at $1,000,000. Eventually however the minimum required withdrawal rate (MDR) will be grater than your cash flow needs. At 115 years of age MDR reaches the maximum of 53% and stays at that rate. In our example by age 83 MDR exceeds cash needs. This means you have to establish a taxable account.

By age 90 your total assets IRA and taxable account from $1,000,000 because of taxable assets are after tax. The after tax assets are still about $600,000. The exact amount depends on the taxes paid on returns of the taxable assets.

For an IRA at age 90 the retirement estate from retirement assets consists of IRA assets of about $925,448 taxable assets $44,731.

For the Roth the retirement part of the Estate consists of IRA assets of $0 and Roth Assets of $600,000.

With an IRA the estate from retirement is $925,448, without estate taxes the beneficiary inherits $44,731 cash and a Beneficiary IRA of $925,448.

The beneficiary has to take taxable MDR's that vary depending on their age from 1.2% at birth to 100% at 112 years.

The Roth beneficiary inherits $600,000 has to make the same MDR's but has to pay no taxes on the distribution. If the beneficiary is younger the IRA is better. The IRA can compound tax free longer, taxes have to be paid later. This advantage is diminished if the tax rates of the beneficiary are higher than that of the original owner.

Payment of taxes on conversion with IRA funds subject to income tax increasing the advantage of the IRA.

3. Owner Draws Down IRA

Under the same assumptions as simplest case the results are similar.

The estate of the IRA holder is $200,145 before taxes, $120,087 after tax. The Roth holder has a Roth (after tax) of $120, 087.

For the individual heir the situation is the same as in the first example.

4. No Withdrawals from IRA

The situation is again essentially the same.

The estate of the IRA holder is $2,525,452. $1,311,168 in a taxable account and $1,214,284 in the IRA. The Roth holder has an Estate of a Roth (after tax) of $2,039,738. Both have the same assets after taxes.

For the individual heir the situation is the same as in the previous examples.

5. Withdrawals from a Regular or a Roth IRA

Roth contributions can be withdrawn at any time penalty free. Funds from Traditional IRAs can only be withdrawn after 59 ½ and a 5 year holding period unless an exception applies.

a. over 69 ½, disabled, or deceased.
b. the withdrawals are part of a scheduled series of substantially equal. payments made at least annually for a minimum of the greater of five years or until the person is at least 59 ½.
c. withdrawal used for higher education expenses by owner, owners children or grandchildren.
d. first time home purchase ($10,000 lifetime max.) by owner or immediate family member.
e. medical insurance premiums during a period of unemployment if person has received federal or state benefits for at least 12 consecutive weeks.
f. Medical expenses that exceed 7.5% of adjusted gross income in any given year.
g. distribution from annuity
h. IRS levy.
i. qualified reservist distributions.

6. Investment Losses in IRA's

In general investment losses in IRA's can not be deducted. However if all funds are withdrawn from the IRA, losses exceeding 2% of gross adjusted income can be deducted. But any withdrawal is subject to income tax.