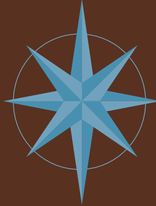

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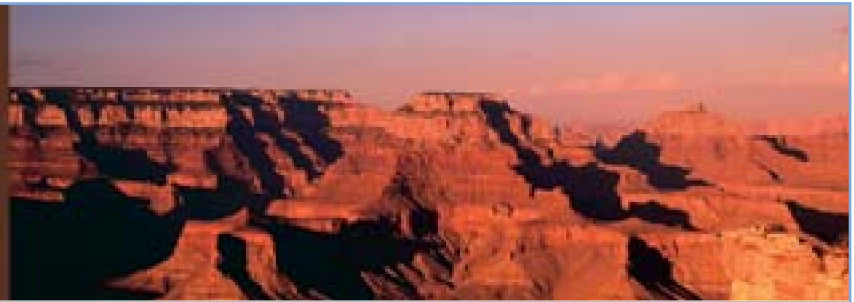

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First Quarter 2010

Best Of Times Often Have Followed Worst Of Times

These have been tough times for strategic long term investors. While it may seem logical to stay the course through the market's inevitable ups and downs—taking advantage of stocks' tendency to deliver strong returns over very long periods—that logic was little comfort during the bear market, when some portfolios lost more than half their value. Wouldn't it have been better to bail out in, say, late 2007, replacing stocks with cash or with bonds, which have outperformed equities during most of this decade?

Of course it would have been better, but myriad problems stand in the way of executing a successful market timing strategy, which calls for getting out of investments before they swoon and getting back in when they're ready to rise. To investigate market timing's feasibility, Donald Bennyhoff and Yan Zilbering at the Vanguard Group recently examined the performance of the Standard & Poor's 500 stock index from 1928 through 2008 and reported their results in a research note, "Market-Timing: A Two-Sided Coin." Looking only at prices—they left aside dividends because of a lack of data on daily total returns before 1980—Bennyhoff and Zilbering found that the index had returned an average of 5% a year during that 81-year stretch. A clairvoyant investor who had managed to be out of the market on just the 20 worst trading days—avoiding an average loss on those dark days of 9.2%—would have gained 7.5% annually. Anyone who had missed the 20 best days, on the other hand, would have gained only 2.6% a year. That amounts to a 50% swing, up or down, in portfolio performance.

No one could ever hope to forecast all of the market's best and worst days. But given that infinitesimally small changes—being out of the market on just 20 of 20,340 trading days during the 81 years the researchers considered—can have a profound impact, it may seem worthwhile to try to identify some of them. What if, for example, you got out of the market after it had a particularly bad day, or got in after a really good one? Wouldn't more of the same be likely to follow?

Often that's not the case, according to Bennyhoff and Zilbering. Frequently the best and worst days happen within shouting distance of one another, and some of the best days have been particularly likely to follow hard on the heels of some of the

(Continued on page 4)

10 Worst Days for S&P 500 Index and Returns for Five and 20 Trading Days Following

Date	Return	Next 5 days	Next 20 days
10/19/1987	-20.5%	1.2%	9.6%
10/29/1929	-16.1%	4.6%	2.5%
5/14/1940	-10.3%	-11.1%	-3.8%
11/6/1929	-9.9%	-14.3%	8.9%
10/15/2008	-9.0%	-1.2%	-6.1%
12/1/2008	-8.9%	11.5%	9.1%
7/20/1933	-8.9%	1.0%	1.8%
9/29/2008	-8.8%	-4.5%	-23.3%
7/21/1933	-8.7%	8.1%	9.6%
10/26/1987	-8.3%	12.3 %	6.7%
Average	-10.9%	0.8%	1.5%

Source: Vanguard

When To Take Social Security Is An Important Decision

You've been paying Social Security tax your entire career, so it's only natural to look forward to the promised "payoff" in retirement. But Social Security isn't like other promises from the government. The benefits you're entitled to receive are actually a unique asset and should be considered in your investment planning.

The full retirement age for those born from 1946 through 1954 is age 66. It gradually increases to age 67 for those born between 1954 and 1960. If you choose to start receiving Social Security benefits at age 62, you'll get your money sooner, but the monthly benefit will be reduced by 25%. On the other hand, if you wait until age 70 to start receiving benefits, the amount is increased by up to 8% per year, in addition to annual cost-of-living hikes.

Let's say your monthly benefit at the full retirement age of 66 is $1,000. Taking early retirement benefits at age 62 results in a permanent decrease to $750 a month. But waiting until age 70 would produce a monthly benefit of $1,320, a 32% increase.

Waiting to begin benefits isn't the best approach for everyone. Whether you should or could do it depends on numerous factors, including your current and anticipated cash needs, your health status and family history, if you plan on working during retirement, other sources of retirement income, and the projected amount of your Social Security benefit. We'll consider all these factors and help you decide how best to utilize this asset.

A Welcome Spike In Personal Savings

Are you looking for something good that may have come out of the recession? As a result of the economic downturn, Americans have generally been spending less and saving more. The savings rate in U.S. households in 2009 reached a high point of 6.9% of after-tax personal income in May. Even though the savings rate has slipped slightly since then, the watershed mark was the highest rate since 1992, when savings peaked at 7.7%.

While it's not an exact measure of fiscal health, the savings rate is the percentage of household disposable income that is put into savings rather than consumed. Mortgage payments are not considered savings, but retirement plan allocations (not capital gains) are. Although a sub-7% savings rate isn't much to brag about in most parts of the world—the annual percentage in other countries routinely hits double digits—it marks a dramatic shift in our personal financial habits. During recent years, the percentage of savings actually dipped below 1%, bottoming out at 0.4% in both 2006 and 2007. In 2008, the saving rate was still only 1.8%.

What's behind the trend towards more savings? During the preceding two decades, rising stock market values and home prices had enticed consumers into thinking they had money to burn, and they became less and less inclined to save for retirement and other needs. Even retirees were encouraged to spend like there was no tomorrow.

But the recent precipitous decline in household wealth ended the wild spending spree. Real estate values around the country have dropped by an estimated 35%, and during the past two years, U.S. household wealth has been reduced by a whopping 140% of annual disposable income. That's a total of $14 trillion.

Faced with daunting economic news, people have been forced to rein in spending, while increasing their efforts to prepare for a secure retirement. For instance, instead of buying goods with their checks from the economic stimulus package or taking advantage of other tax incentives, many people have chosen to hold on to the money. And it doesn't look as if things will change radically anytime soon.

How long will the latest trend last? Most economists predict a slow, steady climb back to better times rather than a quick return to another financial boom. But cutbacks in domestic consumption will also slow down the economic recovery. In the meantime, the savings rate is expected to rise gradually until it hits the 10% mark at some point during the next 10 years. Other financial experts believe the recovery period could last even longer.

Of course, an increased savings rate is to be applauded, especially after it had plummeted dangerously close to zero. Americans will have to adjust to a lower standard of living compared with the heyday of 2007. But if forgoing a few luxuries is the price you have to pay for protecting your financial future, that's probably a trade-off you'd be willing to make. ●

Convert Your 401(k) To A Roth In One Step

A recent pension law change simplified the rules for rolling over assets from a 401(k) plan to a Roth IRA, and another change in 2010 means almost anyone can make such a move. You can now accomplish your objective in one move, instead of the two steps previously required, and that could make this a convenient way to guarantee tax-free income during retirement.

If you participate in a 401(k) plan at work, you get to defer part of your pre-tax salary to your account. You can generally contribute up to $16,500 to a plan in 2009 and 2010 ($22,000 if you're age 50 or over). In addition, your employer may make matching contributions up to a maximum percentage of your salary. Account investments grow without being taxed, and there's no tax due until you begin taking distributions from your account. Those withdrawals are taxed as ordinary income. Although there's normally a 10% penalty tax on withdrawals before age 59½, you may qualify for one of several exceptions (for example, early retirement at age 55).

One way or another, you have to pay the piper one day on the money in your 401(k). But you may be able to absorb the income tax hit now, by converting your account to a Roth IRA. Though the amount you convert will be fully taxed—assuming it consists entirely of tax-deferred contributions and the investment gains attributable to those contributions—later distributions from the Roth during retirement normally aren't subject to any taxes.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to transfer funds from a 401(k) plan to a Roth IRA (assuming your employer plan permitted such transfers). First, you had to roll over funds to a traditional IRA, a transfer that's exempt from tax liability if completed within 60 days. Next, you had to

The New Pension Law's Hidden Treasures

Responding to the severe economic downtown, Congress passed an emergency package of pension law changes late last year. The Worker, Retiree and Employer Recovery Act of 2008 (WRERA) temporarily suspends the rule requiring annual distributions from qualified retirement plans and IRAs. But the new law also does much more. Dig a little deeper and you'll find additional breaks for individuals and employers, as well as important clarifications of the Pension Protection Act of 2006 (PPA). Consider these key provisions of the new legislation.

One-time break on required minimum distributions (RMDs). This is the part of the law that has grabbed most of the headlines. Normally, you're required to begin distributions from IRAs and qualified retirement plans such as 401(k)s or 403(b)s by April 1 of the year following the year you turn age 70½. And the penalty for not taking the full RMD is severe—50% of the required amount you failed to pull out of the account. Normally, the only exception to this requirement applies to participants in employer-sponsored qualified plans who are still working and own less than 5% of the company.

If you have a large account balance, mandatory withdrawals may be substantial, and they come at an inopportune time, when the bear market likely has cut sharply into the value of your retirement accounts. To alleviate the strain on retirees, Congress has waived the distribution requirement for defined contribution plans and IRAs (but not defined benefit plans) though only for the 2009 tax year. If you turned age 70½ in 2008, you'll still have to take that tax year's distribution by April 1, 2009. Yet while you would ordinarily have to take a second mandatory withdrawal, for the 2009 tax year, by December 31, the new law lets you skip it. And if you're turning age 70½ this year? You're not required to take the RMD for 2009 that would have been due April 1, 2010, though you'll still be on the hook for the 2010 distribution, which you must receive by December 31, 2010.

The temporary suspension also applies to beneficiaries who have inherited retirement plan assets. The new law eliminates the required distribution for the 2009 tax year.

Clear rules on nonspouse rollovers. Prior to the PPA, only a surviving spouse was permitted to make a tax-free rollover from an inherited qualified plan to a traditional IRA. Nonspouse beneficiaries, such as a child or grandchild, didn't qualify. But the PPA authorized tax-free rollovers for trustee-to-trustee distributions made after 2006.

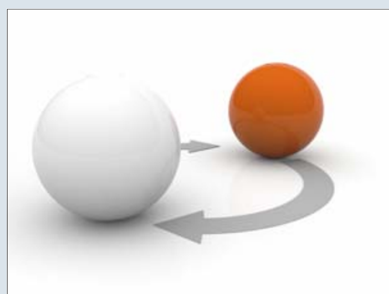
Originally, the IRS said employers weren't legally obligated to offer this option to beneficiaries of their qualified plans; then it flip-flopped on the issue. The new law settles the matter, establishing that for plan years after 2009, the rollover option for trustee-to-trustee transfers is mandatory.

Single-employer pension funding relief. One PPA goal was to shore up defined-benefit pension plans, requiring employer-sponsored plans to move quickly toward 100% funding of their obligations. Now, though, many companies in dire financial straits may have trouble meeting government targets, which called for 94% funding in 2009. Under the PPA, failure to meet the target triggers the so-called cliff rule, which calculates the plan's shortfall by comparing funding to 100% rather than to the target percentage. So a plan that was 93% funded in 2009 would have a 7% deficit, not 1%. WRERA eliminates the cliff rule and gives plans that miss the target seven years to catch up. That helps employers whose obligations have soared as the value of pension fund investments has spiraled downward.

Extra time for multi-employer plans. The PPA created specific funding rules for multi-employer plans classified as "endangered" or "critical." The new law eases some of those requirements. For example, a plan that has suffered losses may be able to freeze the prior year's funding certification status. And whereas plans had 10 years to improve funding under the PPA, now some will have 13 years—and plans considered "seriously endangered" will get 18 years, not 15.

Finally, WRERA includes numerous corrections to the PPA and technical changes related to at-risk plans, hybrid plans, automatic enrollment plans, and other pension-related provisions of the tax code. We can work with you and your benefits professionals to sort through the changes and help you or your business navigate this difficult economic environment. ●

convert the traditional IRA to a Roth IRA and pay the resulting tax. To further complicate matters, Roth conversions had previously only been allowed in a year in which your adjusted gross income is $100,000 or less.



Now, these strict rules have been loosened. Under the PPA, you can transfer 401(k) assets directly to a Roth IRA. This change applies to distributions made after 2007. What's more, as of January 1, 2010, the $100,000 ceiling no longer applies, and for conversions in 2010, you can spread out the tax you owe over the following two years.

The IRS has also issued guidance allowing tax-free 401(k) transfers to a Roth IRA of up to the amount of after-tax contributions you may have made to your employer plan (Notice 2008-30). That could be better than a two-step transfer, because when you convert from a traditional IRA to a Roth, the tax-free amount is limited to a pro-rated portion of nondeductible contributions to all of your IRAs. With a one-step transfer, it doesn't matter what's going on in your other retirement accounts. ●

Splitting Up Your Roth IRA Conversions

What may be an optimal time to convert a traditional IRA to a Roth IRA has arrived. Beginning in 2010, high-income taxpayers qualify to make the switch, and for some, the basic trade-off of a conversion—paying income tax now in return for tax-free income during retirement—could be worthwhile. As an added incentive, taxes on conversions made in 2010 can be paid during the following two years. Yet with markets unsettled, a conversion could backfire, leaving you to pay income taxes on assets that have lost value after the transfer to a Roth. Establishing multiple Roth IRAs, rather than just one, could give you the flexibility to minimize the damage.

By splitting up a converted Roth, you avoid having to make an all-or-nothing choice about whether to "recharacterize" the account back into a traditional IRA. The IRS gives you that option, allowing you to undo a conversion and avoid the associated taxes. But you can't do a partial recharacterization, returning only selected assets to the traditional account.

That's the benefit of establishing multiple Roths. You might use one account for stocks, for example, and a second for non-stock investments such as bonds. Then, when it's time to file your tax return for the year of the conversion, you can look at the investment performance of each account. If stocks have fallen while bonds were positive, you might decide to recharacterize the stock Roth IRA but leave the other alone.

In fact, rather than just creating two Roth accounts, you can go even further with this technique, subdividing the "stock" account by industry sectors or capitalization.

The old rule for conversions, which required an adjusted gross income of $100,000 or less, is eliminated in 2010. But those who choose to convert a traditional IRA to a Roth IRA will still owe income tax on the converted amount that's attributable to tax-deductible contributions and earnings. (Non-deductible contributions are exempt.) That tax is particularly painful if the value of account investments has fallen sharply, and many account owners who converted early in 2008 undid the conversion after the stock market plummeted later in the year.

You have until your tax return due date, plus extensions, to change things back to the way they were.

By splitting your assets into separate accounts, you can wait to see how each account performs. The earlier in the year you make the conversion, the longer you'll have to make a final decision.

For example, if the conversion took place on January 1, 2010, you have until April 15, 2011, to decide about a recharacterization—or until October 15, 2011, if you elect an extension.

What if you determine that future investment performance will improve for that asset class you just recharacterized? You can "reconvert" your traditional IRA to a Roth, but not until the start of the following year or 30 days after the recharacterization, whichever comes later. ●

Best Of Times Follow Worst

(Continued from page 1)

worst. In dramatic turnarounds, eight of the 20 best days occurred within 10 trading days of one of the worst 20 days. On October 29, 1929, the S&P sank by 16.1%; the next day, it soared 12.5%. In 2008, a 7.6% loss on October 9 was followed by an 11.6% gain on October 13.

Post-plunge rebounds often last more than a day, with the market frequently recouping, during the next few weeks, a significant fraction of what it has lost. For example, the worst sell-off in the Vanguard study—on October 19, 1987, when the S&P 500 lost 20.5% of its value—was quickly followed by a lot of buying. Within 20 trading days of Black Monday, the market had rebounded by 9.6%. A similar thing happened during the 1929 crash; after that 16.1% free fall on October 29, the S&P stabilized temporarily, regaining 2.5% during the 20 trading days that followed. And in 2008? Twenty days after December 1, when the market fell 8.9%, it had regained 9.1%. Looking at the S&P's performance following all 20 of the worst days, the market regained an average of 2% during the next 20 trading days.

For would-be market timers, those tendencies make a difficult job virtually impossible. While it may be feasible to anticipate broad market shifts and to make tactical adjustments to a portfolio based on certain metrics like price-to-earnings ratios, any attempt to time a wholesale market entrance or exit will probably fail. Few people expected the stock market to surge when it did in the spring of 2009, or to advance as much as it did during the next several months. Investors who had cashed out their portfolios during the market rout almost certainly missed some (if not all) of the rally.

The recent volatility of the S&P 500—from day to day, week to week, and month to month—only reinforces how unlikely it would be for anyone to get in or out at just the right time. Rather than try to time the market, which almost always backfires, most investors would do better to stick with a well-diversified portfolio with regular asset allocation rebalancing to keep volatility in check and increase potential long-term gains. ●

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