

To Roth or Not to Roth

Traditional to Roth IRA conversions have been in the news lately because in 2010 the rules have changed regarding who is eligible to convert. In the past, conversions weren't allowed if you had more than \$100,000 of income. As of January 1, the income limit is gone.

This is a big change since Roth and Traditional IRAs are treated differently when it comes to taxes. Money put into a Traditional IRA is generally tax deductible when deposited, and then is taxed on withdrawal. A Roth is the opposite, you deposit money that has already been taxed, and then your withdrawals are tax-free. In addition, unlike a Traditional IRA which has mandatory distributions beginning at age 70 ½, there is no requirement to withdraw money from Roth IRAs. Income, dividends and gains on invested money in both a Roth and Traditional IRA are compounded tax free.

However, a conversion from a Traditional to a Roth, generally results in a significant tax liability. This can be either paid with money that is outside of the IRA account, or from the assets inside the account. If the money to pay the taxes is taken from within the account, and you are younger than 59 ½ years old, you will also be subject to a 10%

early withdrawal penalty. Taxes on conversions in 2010 can also be spread out over two years. However, if Congress allows the current tax cuts to expire some people may see a higher income tax rate in 2011 resulting in more taxes due.

Calculating whether or not this conversion makes sense for you is a complex issue. The calculation should include what could have been in the account and allowed to grow had the taxes not been paid. The calculation also requires a futile attempt to guess what the future tax code will be and how it will apply to your situation. You can convert all or part of your Traditional IRA, or do many conversions over multiple years.

Obviously, deciding whether or not to make a conversion can be a very confusing and complex process. It may make sense if you don't plan on needing to use your IRA in retirement and would like to pass it along to your children, or if you know you will have a high income in retirement. Alternatively, converting only part of your assets may make sense to hedge against changes in the tax code. Clients of Sigma whose circumstances permit a Roth conversion should plan to meet with their investment manager, and tax advisor, to determine if a conversion makes sense.

summaries

The Economic and Market Environment

In Sum: More gains ahead for common stocks, or relapse? This matters little for long term investors as it is fruitless to try to "time the markets." The returns from stocks were powerful in 2009 and over the longer term still represent the preferred investment for total return. Bonds, on average, provided high single digit returns in 2009. Rising interest rates on longer maturity fixed income instruments are beginning to reflect improving economic fundamentals and recent statistics on emerging economic conditions supports this view. With the receding economic crisis, coordinated global prescriptions for same will wane and in the US, domestic issues (healthcare, greenhouse gases, taxes) will dominate congressional debates. The recent surprising Massachusetts senate election changes the dynamic.

Geo-political: Iran continues to occupy center stage for Obama foreign policy as protests inside that country have intensified following a lull in the latter half of 2009. The conundrum is whether the Obama Administration should support regime change, or use the unrest as an opportunity to wrest nuclear concessions from that country. North Korea signaled an interest in resuming denuclearization talks early in 2010 in its rendition of the movie "Groundhog Day." Venezuela recently devalued its currency, leading many to conjecture resulting social unrest. Argentine President Kirchner attempted to fire that country's central

banker for refusing to provide reserves for her political priorities. Broadly speaking, countries led by autocratic figures are experiencing continued vulnerabilities while democratic/capitalist systems are stabilizing with improving economies. Unanswered: What leadership will Russia and China provide in 2010 on foreign policy matters?

Economic: As predicted in this space for the past several months, global economic activity continues to show signs of improvement. Economic resilience is underpinned by opportunity and business has stepped up to take advantage of uncertainties. China continues to industrialize and Brazil is diversifying its once concentrated, resource based economy. In the US, reported and anecdotal evidence (outside of unemployment statistics) supports a case that economic recovery continues.

Monetary: At its Federal Open Market Committee meeting in December, 2009, Chair Ben Bernanke and colleagues signaled again that economic fortunes were improving, but without sufficient momentum to suggest a rise in inflation and hence, a hike in interest rates. As noted in prior Sigma Summaries, other central bankers in other parts of the globe have begun to raise interest rates and the same can eventually be expected in the US.

Fiscal Policy: The Obama Administration, responding to a poor jobs report from the US Labor Department in early January indicated further plans to allocate funds for job creation. As deficit spending looms as a rising concern to voters (heightened by expectations of large increases in health care entitlements), significantly greater latitude

to spend appears limited. As deficit spending looms as a rising concern to voters (heightened by the upset senate election of Republican Scott Brown in Massachusetts), significantly greater latitude to spend appears limited.

Equity markets: Following the lows reached in March, 2009, global equity markets staged a powerful rally that continued into the final quarter of the year. While the Standard & Poor's 500 Stock Index is not an all-encompassing, global benchmark, it is well understood and followed, and as a result, its statistics are a good indication of investment performance. Following the March lows, this index gained 68% and for the year, returned 27%. Over the last 50 years, the index has produced an average annual return of 9.4%.

Fixed income markets: The total investment return (in percentage terms) on a diversified portfolio of bonds was in the high single digits in 2009. Short term interest rates continue at low levels, while longer maturity bonds have seen some pick up in yield providing evidence that the marketplace believes inflation will increase in the future. The aforementioned softness in US jobs did give the fixed income markets pause, as rates declined modestly after the announcement. Still, it appears that the weight of the evidence is for moderately higher future consumer prices.

I'm OK, You're OK

I have just written what I believe to be my last of 25 tuition checks to the University of Michigan

(I write "believe" because I have noticed that we are now receiving applications to law schools in the mail, addressed to our youngest daughter Megan). Megan is a senior at Michigan, and informs me that she will indeed graduate in April. What a relief!

I recall looking up that "mountain" of tuition obligations 20 years ago or so and wondering how I was ever going to scale it with no other means outside of my wages (which were comparably modest back then). It was intimidating. My parents thought they "owed" me an education and Shari and I carried that same sense of duty.

Now that I am on the other side of that mountain, there is a certain sense of satisfaction in having fulfilled one of my life's purposes. Hopefully, I can continue to provide my girls guidance so that as they move into their next phases of continuing education they can assert good judgment and productively shape their worlds.

My purpose in including this short commentary is two fold. First, friends of the firm frequently ask me for family updates and I am obliging in that regard. The second is to remind the many clients of our firm that we at Sigma face most of the same financial challenges and hurdles that they do (including caring for aging parents, responding to charitable requests, et. al.) and we apply to our situations the same advice that we apply to theirs. Their personal issues are our personal issues. We stand ready to serve by providing advice in excess of the day to day portfolio management requirements.

local independent personal accessible
interactive creative local independent personal
knowledgeable thoughtful ethical experienced

In that regard, we have recently extended our capabilities by investing in an enhanced analytical application that we believe allows us to measurably improve our wealth planning activities on behalf of our clients. This has been enthusiastically embraced by the handful of clients for whom we have already utilized the module, translating what used to be very complex, abstract concepts into practical, understandable components and strategies.

While we expect to implement this application broadly for all clients over the course of the next several months, please feel free to call your portfolio manager if you are interested in accelerating this implementation for your circumstances.

Robert M. Bilkie, Jr., CFA

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