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# RETIREMENT INSIGHTS

SUMMER 2010

## Should You Convert to a Roth IRA?

“Approximately 40% of U.S. households own individual retirement accounts (IRAs), which account for 25.4% of retirement wealth and 8.5% of all financial wealth in the United States.”

Source: Investment Company Institute, 2009

**E**FFECTIVE IN 2010, all taxpayers, regardless of the amount of their adjusted gross income (AGI) or tax filing status, can convert a traditional individual retirement account (IRA) to a Roth IRA. Amounts converted must be included in income if taxable when withdrawn (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs), but they are exempt from the 10% early withdrawal penalty.

If you make a conversion in 2010, the taxable amount will be included in two installments, half in 2011 and half in 2012, with no tax due in 2010. However, if you prefer, you can elect to pay the tax in 2010, which may make sense if the current lower tax rates are not extended beyond 2010 or you expect much higher income in 2011 or 2012. Taxes on conversions made after 2010 must be paid in the year of conversion.

The question is whether it makes financial sense to pay what could be a large income tax bill now to avoid any future income taxes on your IRA. Several factors need to be considered before answering that question:

**WHAT IS YOUR INCOME TAX BRACKET NOW, AND WHAT WILL IT BE WHEN THE FUNDS ARE DISTRIBUTED?** If your tax bracket will be the same at both times, the financial results will be similar. Increasing income tax brackets generally make it advantageous to convert to a Roth IRA, since you are paying the tax bill while income tax rates are lower. Decreasing tax brackets generally favor leaving the balance in the traditional IRA.

**HOW WILL YOU PAY THE INCOME TAXES DUE FROM THE CONVERSION?** If you can pay the tax bill from sources outside your IRA, that is a strong factor in

favor of conversion. By doing so, you are in essence making an additional contribution to the IRA in the amount of the tax paid. Conversely, paying the tax bill from your IRA account can be a strong factor against converting, since you are withdrawing funds from your IRA and may also have to pay a 10% penalty on that withdrawal.

**WHEN WILL YOU MAKE WITHDRAWALS FROM YOUR IRA?** If you'll make withdrawals within five or 10 years of converting, that may not be enough time for the benefits of tax-free compounding to compensate for the current payment of income taxes. But if you don't need to make withdrawals, your balance in a Roth IRA can grow tax free for a longer time, since

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## Advice on Saving for Your Child

**Y**OUR CHILD HAS finally finished college and started his/her first full-time job. What is the most important financial advice you can give?

Participate in your 401(k) plan as soon as you are eligible. The quality of your child's retirement will largely be determined by the amount of money he/she saves, and a 401(k) plan is a great place for him/her to start. Before marriage, a new home, or other obligations consume his/her entire paycheck, get him/her into the habit of saving. Because the contributions are deducted before he/she even sees his/her paycheck, it's a great way to get him/her into the habit of saving on a regular basis.

Having trouble convincing him/her this is a  
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## Advice on Saving for Your Child

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good strategy? Perhaps some numbers will make the point. Assume your child starts contributing to his/her 401(k) plan at age 25, contributing \$6,000 per year (substantially below the maximum contribution in 2010 of \$16,500), with matching employer contributions of \$3,000. If he/she earns a hypothetical 8% annually, he/she could have a balance of \$2,331,509 at age 65, before the payment of any taxes. What if he/she waits until age 35 to start contributing? At age 65, the balance could be \$1,019,549, still a substantial amount, but \$1,311,960 lower than if he/she started at age 25. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment vehicle.)*

What if your child still isn't convinced? Consider reimbursing him/her, as part of your annual gift tax exclusion, for any 401(k) contributions. You can reimburse the entire amount or offer to make a partial reimbursement.

Don't let your child procrastinate because there are too many decisions to be made. Just encourage him/her to start contributing, reassuring him/her that none of the decisions are permanent. He/she can review contribution levels, investment choices, beneficiary designations, and other matters at a

later date.

If your child has the option to contribute to a regular 401(k) plan or a Roth 401(k) plan, suggest contributing to the Roth 401(k). Employer matching contributions will still be made to a regular 401(k) plan, but your child's contributions can go to the Roth 401(k). Your child won't get a current tax break for contributions made, but he/she will owe no taxes on the contributions or any earnings when withdrawals are made.

What if your child doesn't have a 401(k) plan at work? Encourage him/her to contribute to an individual retirement account (IRA). Although contributions are limited to \$5,000 in 2010 compared to \$16,500 for 401(k) plans, IRAs are still a good way to save for retirement. ✓✓✓



## Clamp Down on Spending

**I**F YOU'RE TRYING to increase savings, remember that savings are directly tied to spending — the less you spend, the more you have to save. Some tips to help you clamp down on your spending include:

- ✓ Analyze your spending for a month. Are you surprised by how much you spend on dining out, groceries, entertainment, or clothing? Give serious thought to your purchasing patterns, looking for ways to reduce spending. Clean out your closet and really assess whether you need new clothes. Cut back on how often you dine out or at least go to less-expensive restaurants. Rent a movie instead of going to the theater. Make a list before grocery shopping and don't deviate from it. Look for coupons and sales before shopping.
- ✓ Go over major expenditures also. When was the last time you comparison shopped your auto or homeowners insurance? Have you checked mortgage rates lately to see if you should refinance? Have you reviewed strategies to reduce your income taxes?
- ✓ Make a spending plan and put it in writing. Budget for all major expenditures and resolve not to purchase items that aren't in your budget.
- ✓ Throw out your credit cards (or at least hide them for a while). Most people find it more difficult to spend cash than to charge a purchase. So, for the next couple of months, only purchase items with cash.
- ✓ Don't purchase items over a fairly low dollar amount until your second shopping trip. How often have you purchased something on impulse, only to realize when you got home that you really didn't need it? To control those impulses, compare price and value on your first shopping trip. Then go home, think about whether you really need the item, and purchase it on another trip.
- ✓ Think carefully before making major purchases. Often, upkeep and maintenance will add to your costs. Consider a less-expensive car or a used car. Keep your car for four or five years instead of getting a new one every two or three years.
- ✓ Figure out the maximum amount you can afford for a house and then buy one substantially less expensive than that. Not only will you save on your mortgage payment, other costs associated with owning a home will be lower. Living well within your means is one of the best ways to ensure you have money left over for saving. ✓✓✓

## Should You Convert to a Roth IRA?

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you don't have to make required minimum distributions after age 70 1/2.

**HOW WILL THE INCOME FROM THE CONVERSION AFFECT YOUR OVERALL TAX SITUATION?** That additional income could raise your overall income to a point where you lose some tax credits, deductions, or exemptions in the year of conversion, or increase Medicare premiums.

**WILL YOUR SOCIAL SECURITY BENEFITS BE SUBJECT TO TAXES?** In the year of conversion, the income from the conversion may affect your Social Security benefits. However, going forward, distributions from Roth IRAs are excluded from taxable income, while distributions from traditional IRAs may affect your benefits if you have significant amounts of taxable income from other sources.

**ARE YOU INTERESTED IN OTHER ESTATE PLANNING CONSIDERATIONS?** Paying income taxes currently means that you remove those assets from your taxable estate, thus reducing estate taxes owed at your death. If you plan to leave the IRA balance to your heirs, they receive the Roth IRA proceeds free of income taxes, while income taxes would be due on the traditional IRA. Also, if you don't take withdrawals from the Roth IRA after age 70 1/2, you may end up leaving your heirs with a much larger balance.

After considering all of these factors, you can decide whether converting makes sense for your situation. Keep in mind that you do not have to convert your entire IRA balance at one time. You can convert over a number of years or only convert a portion of your IRA balance. However, be aware that if you have both deductible and nondeductible IRA balances, you cannot just convert the nondeductible balances to reduce your tax liability. You have to assume a pro-rated portion of both the deductible and nondeductible IRA funds are being converted.

### KNOW WHEN TO RECHARACTERIZE

If you convert and your investments then decline, you end up paying taxes on more than the current market value. However, you can then recharacterize your conversion. For conversions made in 2010, you can recharacterize until October 15, 2011, meaning you can convert back to your original IRA. After the recharacterization, it is as if you did not convert, so you owe no taxes. You can then reconvert at the later of 30 days after the recharacterization or the beginning of the tax year following the first conversion.

You can recharacterize just a portion of the conversion. However, if you have several investments in the IRA, you can't simply choose the ones with the largest losses. In that situation, a pro-rated portion of all the investments in the account will be considered in the recharacterization. You can

bypass this rule by setting up separate Roth IRA accounts for each investment. Then, if one declines substantially, you can recharacterize that one Roth IRA account, leaving the other accounts intact.

### ROTH IRA CONTRIBUTIONS

This new conversion provision effectively removes the income limitations for contributions to a Roth IRA. In 2010, Roth IRA contributions can be made by single taxpayers with AGI less than \$105,000 (contributions are phased out with AGI between \$105,000 and \$120,000) and by married couples filing jointly with AGI less than \$167,000 (contributions are phased out with AGI between \$167,000 and \$177,000). It doesn't matter whether you participate in a company-sponsored pension plan. Individuals with incomes over the limits can make contributions to a nondeductible traditional IRA and then immediately convert the balance to a Roth IRA. However, keep in mind that if you have other deductible IRA balances, you will have to assume a pro-rated portion of both the deductible and nondeductible IRA funds are being converted.

Please call if you'd like help deciding whether you should convert to a Roth IRA. *vvv*

## Don't Forget to Rebalance

**S**IMPLY PUT, REBALANCING a portfolio means restoring it to your long-term asset allocation plan so that you get back on track with the risk/reward strategy that meets your goals and risk tolerance.

Rebalancing requires a strategic asset allocation plan. You then know when and what you may want to sell when market forces cause your portfolio to move away from your asset allocation. You may choose to sell some of the assets that have grown to take up too large a share of your portfolio, using the proceeds to buy assets that have decreased from their intended size.

Even with the recent gains in the stock market, most portfolios have still suffered losses over the past couple of years in stocks. Thus, stocks likely will represent a smaller portion of your portfolio than originally intended. If that's true, then the principle of rebalancing requires selling some bonds, using those proceeds to buy more stocks.

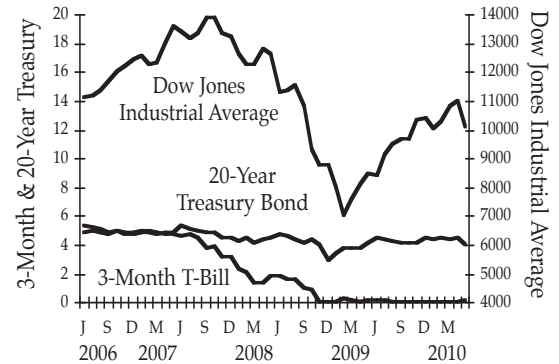
There are several ways to execute a rebalancing strategy. You can sell your worst performers, sell a percentage of your best performers, or cut your holdings across the board. As for timing, you can decide to rebalance according to a calendar date, such as annually or every quarter, or when your positions get distorted by a specific percentage, such as 5% to 10%.

Please call if you'd like to discuss rebalancing in more detail. *vvv*

Market Data	Month End			% Change	
	May 10	Apr 10	Mar 10	YTD	12 Mon.
Dow Jones Ind.	10136.63	11008.61	10856.63	-2.8%	19.2%
S&P 500	1089.41	1186.69	1169.43	-2.3	18.5
Nasdaq Comp.	2257.04	2461.19	2397.96	-0.5	27.2
Wilshire 5000	11402.98	12408.92	12160.97	-0.8	21.2
Gold	1207.50	1179.25	1115.50	9.7	23.8
Silver	18.36	18.78	17.58	8.5	17.5
				Dec 09	May 09
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.00	0.00	0.00	0.05	0.23
3-month T-bill rate	0.17	0.15	0.15	0.11	0.18
20-yr. T-bond rate	4.04	4.50	4.43	4.53	4.22
Dow Jones Corp.	4.28	4.11	4.33	4.43	6.01
Bond Buyer Muni	5.07	5.12	5.28	5.40	5.32

Sources: *Barron's*, *Wall Street Journal* Past performance is not a guarantee of future results.

#### 4-Year Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield June 2006 to May 2010



Sources: *Barron's*, *Wall Street Journal*

## Get Your 401(k) Plan on Track

“Approximately 51% of households are at risk of not being able to maintain their standard of living during retirement, up from 44% in 2007. Almost three-quarters of the increase in the percentage of households at risk resulted from declines in housing values.”

Source: Center for Retirement Research, 2009

FOR MANY PEOPLE, their 401(k) plan represents their most significant retirement savings vehicle. Thus, to make sure you have sufficient funds for retirement, you need to get your 401(k) plan on track. To do so, consider these tips:

- ✓ **INCREASE YOUR CONTRIBUTION RATE.** With investment values down and future stock market returns uncertain, you need to boost your savings to help increase the value of your 401(k) plan. Strive for total contributions from you and your employer of approximately 10% to 15% of your salary. If you're not able to save that much right away, save what you can now and increase your contribution rate every six months until you reach that level. One way to accomplish that is to put all pay increases immediately into your 401(k) plan. At a minimum, make sure you're contributing enough to take advantage of all employer-matching contributions.
- ✓ **REBALANCE YOUR INVESTMENTS.** You can't select your investments once and then just ignore your plan. Review your allocation annually to make sure it is close to your original allocation. If not, adjust your holdings to get your allocation back in line. Selling investments within your 401(k) plan does not generate tax liabilities, so you can make these changes without tax ramifications. Use this annual review to make sure you are still satisfied with your investment choices and your allocation is still appropriate for your situation. Avoid potential common mistakes made when

investing 401(k) assets, such as allocating too much to conservative investments, not diversifying among several investments, and investing too much in your employer's stock.

- ✓ **DON'T RAID YOUR 401(K) BALANCE.** Your 401(k) plan should only be used for your retirement. Don't even think about borrowing from the plan for any other purpose. Sure, that money might come in handy to use as a down payment on a home or to pay off some debts. But you don't want to get in the habit of using those funds for anything other than retirement. Similarly, if you change jobs, don't withdraw money from your 401(k) plan. Keep the money with your old employer or roll it over to your new 401(k) plan or an individual retirement account.
- ✓ **SEEK GUIDANCE.** It is important to manage your 401(k) plan carefully to help maximize your future retirement income. If you're concerned about the long-term impact of the recent market declines, call for a review of your 401(k) plan.

Rebalancing, asset allocation, and diversification do not assure a profit or protect against loss in declining financial markets. ✓✓✓

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