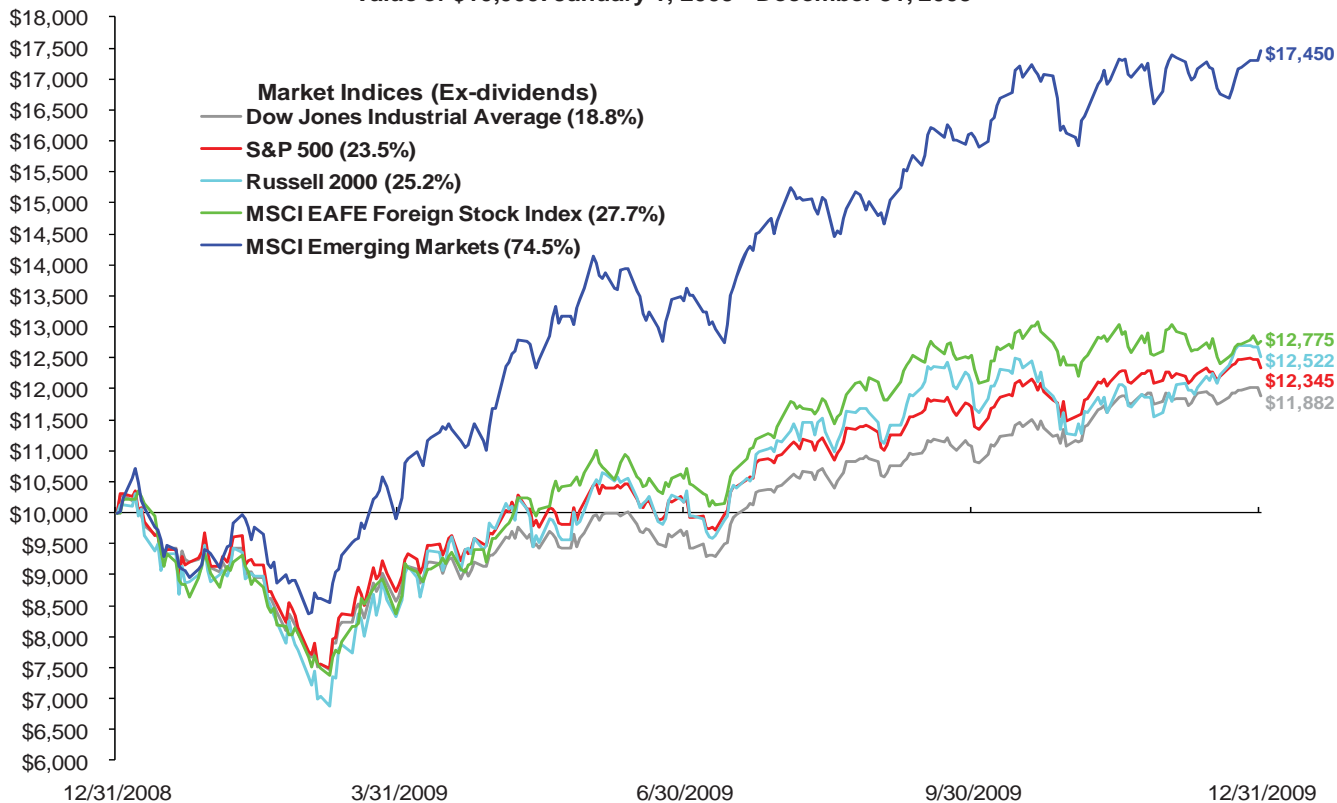


WORLD MARKET SURVEY

Value of \$10,000: January 1, 2009 - December 31, 2009



The World Market Survey article begins on page 10.

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Should you convert your IRA to a Roth IRA? Until January 1 of this year, the question was moot for many investors, because the Tax Code prevented anyone with a Modified Adjusted Gross Income (MAGI) greater than \$100,000 from doing so. But the MAGI ceiling disappeared on the first of the year, making Roth conversions available to anyone (MAGI restrictions still apply to new contributions to Roth IRAs).

The question, really, is whether to pay the income tax on your IRA assets now,

or later. Conversions are taxable events: converted amounts are subject to income tax, just as if they had been distributed. An old saw of the financial planning profession has it that a dollar of tax deferred is a dollar of wealth preserved. Still, converting from a Traditional IRA to a Roth IRA, and assuming the tax liability now, may make sense, depending on individual circumstances.

The most important reason one might be interested in such a conversion is that qualified withdrawals from Roth

IRAs are tax-free. An investor aged 60, who may have a life expectancy of 30 years or more, could find this feature of Roth IRAs extremely appealing, because the tax liability implicit in a Traditional IRA compounds in step with its growth. The Roth also has some advantages over the Traditional IRA from an estate tax perspective. While our readers should consult with a tax advisor before converting Traditional IRA assets to Roth IRA assets, we hope this discussion will help them determine whether such a consultation makes sense.

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Let us first step back and examine the basic features of both the Traditional and Roth Individual Retirement Accounts.

Traditional IRA

The Traditional IRA is available to individuals between the ages of 18 and 70½ with earned “employment” income, or who are married to someone with such income. For taxpayers less than 50 years old, the maximum IRA contribution is the lesser of 100% of earned income or \$5,000 (\$6,000 for those 50 or older). Contributions to a Traditional IRA are tax deductible at any level of income, except for taxpayers covered by a qualified employer-sponsored retirement plan like a 401(k); such taxpayers may receive a reduced deduction, or no deduction, for their IRA contributions. Taxes are not paid on IRA investment returns until qualified withdrawals begin. Qualified withdrawals are taxed at standard Federal Income Tax rates. Withdrawals must start by age 70½, and be calculated in such a way as to exhaust the IRA by the actuarially expected date of death. In most cases, withdrawals before age 59½ will trigger an additional 10% penalty tax. The IRS will waive this penalty for premature distributions used to fund first time home purchases (up to \$10,000), expenses for higher education, death, disability, unreimbursed medical expenses, and health insurance premiums. The penalty is also waived for distributions in the form of substantially equal periodic payments (SEPP), provided they meet certain stipulations. Traditional IRA accounts are often referred to as “tax-deferred” accounts.

Roth IRA

Roth IRAs are open to investors of any age provided they or their spouse have earned income (there are, however, MAGI limits on Roth contributions). By contrast with the Traditional IRA, Roth IRA contributions are never tax-deductible. Roth IRA contribution limits are the same as for Traditional IRAs. As with a Traditional IRA, Roth earnings grow tax-free. But – and here is the key difference between the Roth and the Traditional IRA – withdrawals are free of

taxes and penalties, provided the account has been open at least five years, and distributions occur after age 59½ (or in the event of death or disability, or to fund a first home purchase (up to \$10,000)). Another important difference between Traditional and Roth IRA’s is that there are no required distributions from the latter. Roth IRAs are therefore often referred to as “tax-free” accounts.

Conversions

The right of tax-free withdrawal from a Roth IRA is a clear advantage over the Traditional IRA, and Congress has deigned to permit conversions from the latter to the former. But this isn’t an instance of Congressional beneficence, because conversions generate immediate tax revenues that, had assets remained in Traditional IRAs, might have been deferred for decades. Converting a Traditional IRA to a Roth IRA results in the converted funds being taxed in the year in which they are converted (with the exception of non-deductible contributions, which would suffer no tax upon the conversion - but bear in mind that the as yet untaxed *growth* on nondeductible contributions *would* be taxed). Roth conversions were permitted prior to 2010, but with restrictions on eligibility that prevented many investors from taking advantage of the opportunity: individuals or couples filing jointly with MAGI over \$100,000 – or married taxpayers filing separately – were ineligible.

As of January 1, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) removes these two conversion restrictions (although rules on contributions to Roth IRA accounts are unchanged). The only remaining conversion restriction applies to required minimum distributions: if you are over 70½ and plan on converting a Traditional IRA, the RMD must be distributed prior to the conversion.

Also new, but only for conversions in 2010, taxpayers may defer recognition of the income realized upon conversion in equal amounts to the 2011 and 2012 tax years. At first blush, this may seem to be a beneficial option. However,

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ROTH IRA CONVERSION OPPORTUNITIES IN 2010

with the 2001 – 2003 tax cuts set to expire after 2010, tax rates will likely increase in 2011. See Table 1 for 2010 tax rates and Table 2 for proposed 2011 tax rates. If they are skeptical that Congress will act this year to extend the tax cuts, investors may want to take the option to pay the conversion tax in 2010, rather than taking the default option and deferring the pro-rata income to 2011 and 2012.

Distributions from 401(k), 403(b), Traditional IRA, Rollover IRA, SEP IRA, and SIMPLE IRA (2 years after the initial contribution date) accounts are all eligible for conversion. If the conversion is processed properly, and taxes incurred thereby are paid with funds from outside the IRA, no 10% penalty tax for premature distributions will be incurred, even for investors under age 59½.

Table 1

2010 Federal Income Tax Rates								
Joint Return		Single		Head of Household		Married/Separate		Applicable Tax
From	To	From	To	From	To	From	To	
\$0	\$16,750	\$0	\$8,375	\$0	\$11,950	\$0	\$8,375	10%
\$16,750	\$68,000	\$8,375	\$34,000	\$11,950	\$45,500	\$8,375	\$34,000	15%
\$68,000	\$137,300	\$34,000	\$82,400	\$45,500	\$117,650	\$34,000	\$68,650	25%
\$137,300	\$209,250	\$82,400	\$171,850	\$117,650	\$190,550	\$68,650	\$104,625	28%
\$209,250	\$373,650	\$171,850	\$373,650	\$190,550	\$373,650	\$104,625	\$186,825	33%
\$373,650		\$373,650		\$373,650		\$186,825		35%

What factors should be considered in deciding whether to convert to a Roth?

1. How many dollars are available to convert? Can I make a partial conversion?
2. What are the current tax rates and what do I expect the future tax rates to be when I take the money out?

3. Is it important how I pay the conversion tax?
4. How long do I plan on holding the Roth before distributions begin?
5. What are my cash flow needs?
6. What are my estate planning objectives?

How Much Should I Convert?

Roth conversion is not an all or nothing proposition. It is not necessary to convert the entire eligible amount. A partial conversion in 2010 may make sense, with further partial conversions optional in future years. From a tax perspective, it may be beneficial and prudent to diversify among Traditional and Roth accounts. Some commentators fear

Roth conversion is not an all or nothing proposition. It is not necessary to convert the entire eligible amount.

Some commentators fear that Congress, desperate for tax revenues, might someday tax returns on assets held in Roth IRA accounts.

that Congress, desperate for tax revenues, might someday tax returns on assets held in Roth IRA accounts. While the same motivation could prompt Congress to increase or hasten required minimum distributions from Traditional accounts, this seems less likely, if only because so many more taxpayers have them; the political penalty for taxing holders of Traditional accounts would be much greater than for taxing Roth investors.

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Table 2

2011 Tax Rates under Extended Baseline & as Proposed in 2010 Budget			
Taxable Income		Marginal Tax Rate	
From	To	Extended Baseline	Budget Proposal
Single			
\$0	\$8,425	10%	10%
\$8,425	\$34,200	15%	15%
\$34,200	\$82,850	25%	25%
\$82,850	\$172,800	28%	28%
\$172,800	\$192,000	33%	28%
\$192,000	\$375,700	33%	36%
\$192,000	---	35%	39.6%
Married Filing Jointly			
\$0	\$16,850	10%	10%
\$16,850	\$68,400	15%	15%
\$68,400	\$138,050	25%	25%
\$210,400	\$232,950	33%	28%
\$232,950	\$375,700	33%	36%
\$375,700	---	35%	39.6%
Head of Household			
\$0	\$12,000	10%	10%
\$12,000	\$45,800	15%	15%
\$45,800	\$118,300	25%	25%
\$118,300	\$189,350	28%	28%
\$189,350	\$191,600	28%	36%
\$191,600	\$375,700	33%	36%
\$375,700	---	35%	40%
Tax would decrease			
Tax would increase			

... the rule of thumb is that income-generating assets like bonds are better held in tax-deferred accounts, so as to shelter their yield, which must otherwise be recognized, and taxed, in the year earned.

There is also asset location to consider. At Schultz Collins we have stressed to clients the importance of asset location, and discussed it in past issues of INVESTMENT QUARTERLY. For investors with both taxable and tax-deferred accounts, the rule of thumb is that income-generating assets like bonds are better held in tax-deferred accounts, so as to shelter their yield, which must otherwise be recognized, and taxed, in the year earned. Assets that generate return in the form of capital gains, such as small cap stocks, are on the other hand better held in taxable accounts, because they provide the investor some control over the timing and magnitude of his tax liability for capital gains

earned in such accounts, through trading strategies, accounting method elections, and so forth.

But this strategy is difficult to maintain over the long run. Investors generally defer distributions from tax-deferred accounts as long as possible, instead taking retirement distributions first from taxable accounts, where most of them will generate capital gains tax of 15%, versus an income tax of up to 50% (combined) for distributions from tax-deferred accounts. But as the taxable account thus shrinks, an increasing proportion of the Portfolio's distributions must come from tax-deferred accounts, and generate

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

an income tax liability. In such cases, the investor is “locked in” to paying income tax on more and more of his Portfolio distributions, year after year.

A Traditional IRA that had been converted to a Roth IRA, on the other hand, would enable the investor to take distributions in a given year from the account that created the least current tax liability. During bear markets, the investor could generate Portfolio distributions by selling depreciated assets from his taxable accounts (painful as that might be), so as to lock in capital losses that could be applied to reduce current (and future) taxable income from other sources. During bull markets, when funding Portfolio distributions by selling assets from taxable accounts would generate taxable capital gains, the investor could take distributions free of all tax from the Roth IRA.

An investor with both taxable and Roth accounts would be relatively indifferent to the asset location question. Both accounts could be fully diversified, giving him the greatest number of trading options, vis-à-vis taxes and distributions. Thus if, for example, an investor held emerging markets stock in both accounts, and needed to trim his allocation to that asset class on account of its recent stellar performance, he could do so in the Roth IRA and generate no tax liability.

Notwithstanding all that, some investors might find it beneficial to keep assets in a Traditional IRA. Those who have almost no taxable income at all, and who are thus in a very low tax bracket

Example 1

Same Tax Rate & Taxes Paid from IRA Account		
	Traditional IRA	Roth IRA
Beginning Value	\$1,000,000	\$1,000,000
Tax @ Conversion (25%)	\$0	\$250,000
Ending Value after 20 Years @ 8%	\$4,660,957	\$3,495,718
Tax on Withdrawal (25%)	\$1,165,239	\$0
Ending Value	\$3,495,718	\$3,495,718
	Benefit of Roth Conversion	\$0

– e.g., some real estate investors – might prefer to avoid the tax due upon Roth conversion, and take distributions from a Traditional IRA.

Who Should Consider Converting?

A good Roth conversion candidate anticipates higher future income tax liabilities. There are many reasons why tax liabilities might increase. The most obvious, hanging like the sword of Damocles over all our fortunes, are of course the immense deficits that the US Treasury will be incurring, apparently forever and without limit. But despite our worries about Federal deficits, tax hikes, and economic woes, investors are more likely to see their future tax liabilities increase for reasons having to do with their own personal, financial and professional affairs: e.g., inheritance, business success, sale of appreciated real estate, social security distributions, or benefits from defined benefit plans and deferred compensation arrangements. Further down the pike, many investors will eventually change their tax filing status from married filing jointly to single at the death of the first spouse. If you think your tax liabilities might rise, you should perhaps consider Roth conversion.

As a baseline, let's look at what happens if tax rates stay the same. In Example 1, assume an investor has \$1,000,000 in a Traditional IRA, the income tax rate is constant at 25%, the account grows at 8% per year, and the time horizon is 20 years. Assume also that the investor is 60 years old and is paying the conversion tax from his

A Traditional IRA that had been converted to a Roth IRA ... would enable the investor to take distributions in a given year from the account that created the least current tax liability.

A good Roth conversion candidate anticipates higher future income tax liabilities.

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Example 2

Tax Rate Stays the Same, Taxes Paid from Taxable Account, & Opportunity Cost of Taxable Money			
	Unconverted Traditional IRA	Converted Roth IRA	Conversion Tax in Taxable Account
Beginning Value	\$1,000,000	\$1,000,000	\$250,000
Ending Value after 20 Years @ 8%	\$4,660,957	\$4,660,957	\$1,165,239
Tax Rate at Withdrawal	25%	0%	15%
Tax on Withdrawal	\$1,165,239	\$0	\$174,786
Ending Value Net of Taxes	\$3,495,718	\$4,660,957	\$990,453
Ending Value Net of Opportunity Cost	\$3,495,718		\$3,670,504
	Benefit of Roth Conversion		\$174,786

... the benefit of converting to a Roth is substantial when the conversion tax is paid from outside the Traditional IRA.

IRA account. As Example 1 shows, if the tax rate stays the same there is no difference between keeping the Traditional IRA and converting to a Roth IRA.

As may be seen in Example 2, the benefit of converting to a Roth is substantial when the conversion tax is paid from outside the Traditional IRA. This is particularly true for investors under age 59½, because the IRS treats the conversion as tantamount to an indirect rollover. In an indirect rollover, an IRA custodian mails the investor a check. To effect the rollover and avoid tax on the distribution, the investor must deposit the rollover amount in a successor IRA within 60 days of receiving it from the prior custodian. When taxes on a Roth conversion are paid from within the IRA (even if

the custodian never cuts a check to the investor, instead journaling the affected assets in-house from the Traditional IRA account to the Roth IRA account), the IRS accounts for the taxes paid as a distribution to the taxpayer, which he then used to pay the tax. Thus if the investor were under age 59½ and paid the conversion tax from his IRA, he would most likely incur a penalty tax on premature distributions of 10% of the taxes paid.

In assessing the true cost of paying conversion taxes from outside the IRA, it is important to account for the opportunity cost incurred by using taxable monies to pay the conversion taxes. Let's assume the same 8% rate of return on the \$250,000 conversion tax, had it been retained in the taxable account for 20 years,

Example 3

Income Tax Rate Increases, Taxes Paid from Taxable Account, & Opportunity Cost of Taxable Money			
	Unconverted Traditional IRA	Converted Roth IRA	Conversion Tax in Taxable Account
Beginning Value	\$1,000,000	\$1,000,000	\$250,000
Ending Value after 20 Years @ 8%	\$4,660,957	\$4,660,957	\$1,165,239
Tax Rate at Withdrawal	33%	0%	15%
Tax on Withdrawal	\$1,538,116	\$0	\$174,786
Ending Value Net of Taxes	\$3,122,841	\$4,660,957	\$990,453
Ending Value Net of Opportunity Cost	\$3,122,841		\$3,670,504
	Benefit of Roth Conversion		\$547,662

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Example 4

Tax Rate Stays the Same, Taxes Paid from Taxable Account, & Opportunity Cost of Taxable Money			
	Unconverted Traditional IRA	Converted Roth IRA	Conversion Tax in Taxable Account
Beginning Value	\$1,000,000	\$1,000,000	\$250,000
Ending Value after 5 Years @ 8%	\$1,469,328	\$1,469,328	\$367,332
Tax Rate at Withdrawal	25%	0%	15%
Tax on Withdrawal	\$367,332	\$0	\$55,100
Ending Value Net of Taxes	\$1,101,996	\$1,469,328	\$312,232
Ending Value Net of Opportunity Cost	\$1,101,996		\$1,157,096
	Benefit of Roth Conversion		\$55,100

rather than spent on conversion taxes. The \$250,000 would have grown to \$1,165,239 and – assuming that long term capital gains continue to be taxed at the current 15% for 20 years – a tax of \$174,786 would have been due. Net of taxes this \$250,000 would have grown to \$990,453.

What if tax rates actually increase in the 20 year period? If tax rates increase from 25% to 33%, the value of the conversion to the Roth IRA shows even better results. See Example 3. What if you have a shorter time horizon and plan to hold the investment for just five years? Let's take Example 2 and shorten the time horizon from 20 years to five years. See Example 4. The shorter time frame decreases, but does not eliminate, the value of conversion.

Because Roth conversions increase current income, they may make a great deal of sense if you have deductions in excess of your income, or credits in excess of your tax. Examples would be net operating loss (NOL) carry forwards, business/ordinary losses, deductions and exemptions, charitable contribution carry forwards, and non-refundable tax credits.

The Roth IRA as an Estate Planning Tool

Roth conversion may also be appealing because of the effects of Roth IRAs on wealth transfer situations. Investors who do not expect to call

on their IRAs for retirement funding may be looking to transfer them to heirs or charities. Roth IRAs impose no requirement of minimum lifetime distributions, and maintain their tax-exempt status as they transfer to a spouse or to beneficiaries.

The owner of a Traditional IRA who converts it to a Roth IRA and pays the taxes due upon conversion is in effect relieving his estate, or his heirs, of that same liability, which they would otherwise have had to pay upon taking future distributions from an inherited Traditional IRA. Although the Roth IRA is included in the taxable estate, early payment of the conversion tax reduces the likelihood that growth in the IRA will push the estate into higher estate tax brackets. It is important to note that inherited Roth IRAs are subject to RMD requirements, but the beneficiaries can spread the distributions out over their life expectancies.

If on the other hand the investor desires to bequeath an IRA to a charity, it would make more sense to retain the Traditional IRA, because upon transfer to the charity the IRA is removed from the taxable estate, with no income tax due. But in such cases, a lifetime gift of the IRA to a charity might be advisable. Here it is important to note that charitable gifts of IRA assets is a complex subject in its own right, and beyond the scope of this article.

Roth IRAs impose no requirement of minimum lifetime distributions, and maintain their tax-exempt status as they transfer to a spouse or to beneficiaries.

... inherited Roth IRAs are subject to RMD requirements, but the beneficiaries can spread the distributions out over their life expectancies.

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

Decision Matrix				
Issue	Importance	Don't Convert If:	Convert If:	Partially Convert If:
Future Tax Expectations	The higher the future tax rate, the more valuable the tax-free treatment of distributions from a Roth IRA.	You expect your future tax rate to be lower.	You expect your future tax rate to be higher.	You are uncertain about future tax rates.
Funds to Pay Conversion Tax	It is important to pay taxes on the conversion from sources outside of the IRA.	You can't afford to pay conversion taxes from sources outside the IRA.	You are able to pay conversion taxes from non-IRA account.	You can only pay some of the conversion taxes from outside the IRA account.
Time Horizon	Funds need to be in the Roth IRA account for at least 5 years prior to withdrawal in order to obtain favorable tax treatment.	You will need access to your IRA assets before 5 years have elapsed.	You will not need access to your IRA assets before 5 years have elapsed.	You are uncertain when you will need access to your IRA assets.
Required Minimum Distributions	RMD requirements could bump investors into a higher tax bracket.	RMDs from a Traditional IRA are unlikely to push you into a higher income tax bracket.	RMDs from a Traditional IRA could push you into a higher income tax bracket.	You are unsure about the impact of your RMDs.
Impact on Current Income Tax Bracket	Because the amount converted to a Roth is treated as taxable income, conversion could bump investors into a higher tax bracket.	Conversion would push you into an intolerably high current tax bracket.	Conversion would not push you into an intolerably high current tax bracket.	Partial conversion probably won't affect your bracket too much.
Estate Planning Needs	Investors who plan to pass IRA assets to heir might find that Roth conversion will reduce the taxable estate and provide tax-free income to heirs and beneficiaries.	You plan to pass your IRA on to charity.	You plan to pass on your entire IRA to your heirs and you can afford the tax hit.	You plan to use some of your IRA assets, pass some on to charity, and pass some on to heirs.

... taxpayers have the option of "undoing" a Roth IRA conversion through a process referred to as "recharacterization."

Backing out of a Conversion

Say you convert your \$100,000 Traditional IRA to a Roth IRA on February 1, 2010. In another instance of your typical luck, the market then enters a profound swoon. By April 15, 2011, your Roth IRA is worth only \$50,000. You have to write Uncle Sam a check for the income tax due on the full \$100,000 value of the account as of the date of conversion. Don't you wish you didn't owe those taxes? Don't you wish you had never gone through the Roth conversion?

Well, this is one case where you can profit from 20/20 hindsight. Or, rather, limit the damage you've already suffered, by not rubbing the salt of taxes into the open wound of investment losses. Under Federal law, taxpayers have the option of "undoing" a Roth IRA conversion through a process referred to as "recharacterization." There are no penalties or taxes due upon recharacterization. The deadline for recharacterizing a Roth conversion is the date on which the tax return for the calendar year

ROTH IRA CONVERSION OPPORTUNITIES IN 2010

in which the original conversion took place is due, including any extensions – usually October 15th of the year after the conversion. Partial recharacterizations are also possible; however, if you are not recharacterizing the entire account, it is important to consult your tax advisor, as recharacterizations can get complicated. If you are not recharacterizing the entire account,

Traditional IRA account had been divided into four separate successor Roth IRA accounts, then poorly performing separate accounts can be recharacterized where appropriate, without involving the better performing accounts in the recharacterization at all. Here is an example (see table 3):

Table 3

Account	Value on Initial Conversion @ 1/1/10	Gain/Loss to 10/15/11	35% Conversion Tax Owed @ 10/15/11	Value @ 10/15/11	Recharacterize & Reconvert 11/15/11	35% Conversion Tax Owed @ 11/15/11
1	\$250,000	10%	\$87,500	\$275,000	-	\$87,500
2	\$250,000	20%	\$87,500	\$300,000	-	\$87,500
3	\$250,000	-20%	\$87,500	\$200,000	\$200,000	\$70,000
4	\$250,000	-40%	\$87,500	\$150,000	\$150,000	\$52,500
	\$1,000,000		\$350,000	\$925,000	\$350,000	\$297,500

the net income (loss) attributable (NIA) to the conversion amount being recharacterized must be allocated pro rata to each investment.

Say it's now January 2012, and the market remains low. You have recharacterized your original Roth conversion and are back in your Traditional IRA, but would still like to convert it to a Roth. And you can, so long as you wait until the next tax year after the original conversion or, if later, 30 days from the recharacterization date.

The recharacterization option makes it possible to utilize an account segregation strategy. Let's take our earlier \$1 million conversion example and assume that the Roth IRA conversion account has a total loss of 7.5% from January 1, 2010 until the filing extension deadline of October 15, 2011. If the conversion investments had been bundled together in one account, the entire account would have to be aggregated together when recharacterized, for purposes of calculating the NIA. However, if account segregation was utilized and the original

Account 1 grew by 10% and Account 2 grew by 20% but Accounts 3 and 4 lost 20% and 40% respectively over the same period. The investor elects to recharacterize Accounts 3 and 4 and then convert them back to Roth IRAs 31 days later. Even though the original conversion value was \$1 million, this individual only paid income tax on \$850,000, rather than on the entire \$1 million.

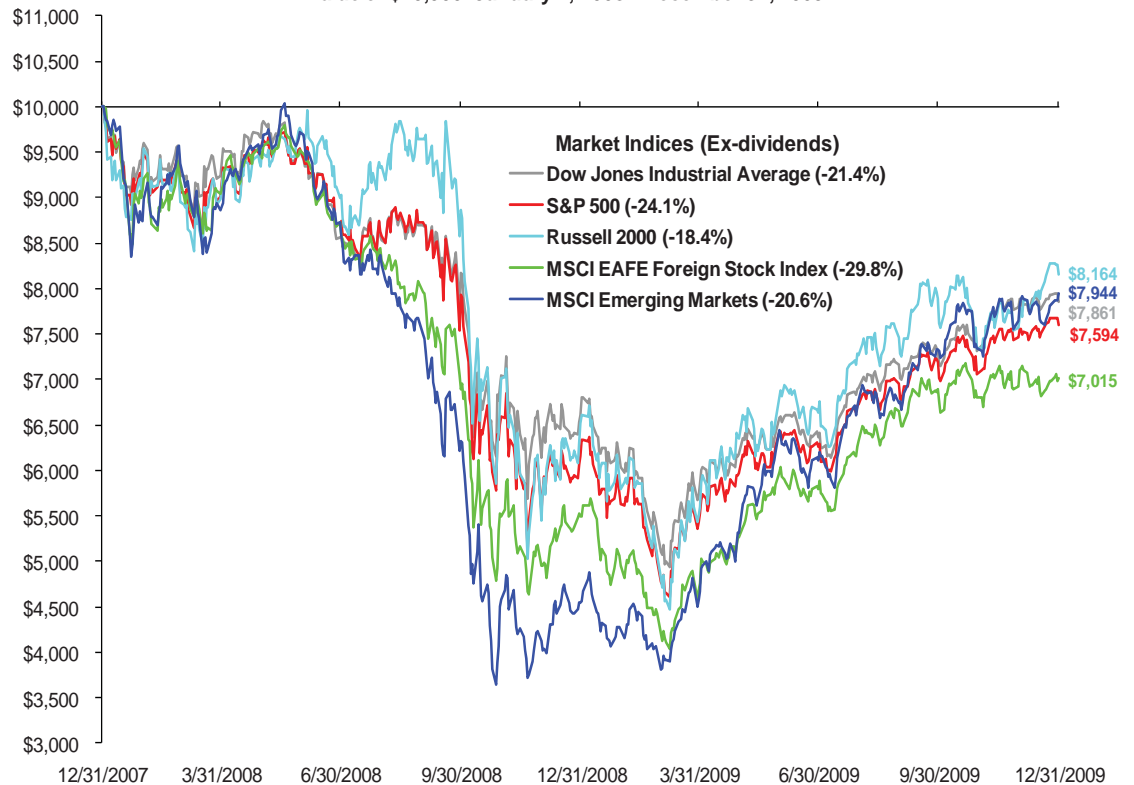
Conclusion

The new Roth IRA conversion rules offer significant planning opportunities for individual investors. In addition, adding Roth IRAs to portfolios can create ongoing opportunities for tax control, on account of different tax treatment of transactions in taxable accounts, Traditional IRA accounts, and Roth IRA accounts. Finally, Roth IRAs can be important estate planning tools. However, each conversion should be examined carefully in light of the investor's unique set of circumstances and goals. It is critical to consult with competent tax professionals before undertaking such steps.

Partial recharacterizations are also possible; however, if you are not recharacterizing the entire account, it is important to consult your tax advisor, as recharacterizations can get complicated.

WORLD MARKET SURVEY

Value of \$10,000: January 1, 2008 - December 31, 2009



In an almost incredible turnaround, US equity markets snapped back from steep losses in early 2009 to stage a stunning recovery by year end. The Dow Jones Industrial Average fell to a 12-year low in early March, declining 25.4% in the year's first nine weeks, and then rallied 59.3% through the remainder of the year, the fastest climb in the Index since 1922. The Dow ended the year with an 18.8% gain. The broader S&P 500 Index advanced 23.5%, and the the Russell 2000 Index of smaller US companies climbed 25.2%. The rally, which caught many investors flat-footed and on the sidelines, was all the more astonishing considering the substantial damage incurred by the global economy and the near collapse of the world's credit markets in the depths of last year's financial crisis.

Stunning Rally in International Stocks

While domestic market returns were welcome results for US investors, the news from abroad was

even better. The MSCI Index of large European Companies increased 35.8% in 2009, and the MSCI Pacific Index advanced 24.1%. Subtracting the Japanese market's relatively anemic return of 6.25%, the MSCI Pacific ex Japan soared 72.8%, on the strength of India (+81%), China (+79.8%) and Taiwan (78.3%). As a group, markets in the emerging economies, including those in Latin America, were up 74.5% in 2009.

The Rally is not yet a Full Recovery

On a more sobering note, amazingly positive 2009 calendar year returns were not enough to offset the decline in market values of 2008 and early 2009 (see chart above). Measured on a cumulative basis over the 24 month period ending December 31, 2009, the Dow Jones Industrial Average and the S&P 500 are down roughly 24%, and the Russell 2000 is off 18%. On the international front, the MSCI EAFE Index of large stocks in developed countries is off 29.8% for the two year period and

SURVEY OF INDICES & FUND AVERAGES
PERIOD AND ANNUALIZED COMPOUND TOTAL RETURNS IN PERCENT

	Fourth Quarter 2009	Total Return Annual 2009	3 Years Ending 12/31/2009	5 Years Ending 12/31/2009	10 Years Ending 12/31/2009
Inflation Index & Risk Free Rate					
Consumer Price Index	0.86	2.68	2.24	2.53	2.56
U.S. 3-Month Treasury Bills	0.03	0.16	2.22	2.88	2.84
U.S. Stock Market (Large Companies)					
Standard & Poor's (S&P) 500 Index	6.04	26.46	-5.63	0.42	-0.95
S&P/Citigroup Large Cap Growth Index	7.76	31.57	-2.24	0.96	-3.57
S&P/Citigroup Large Cap Value Index	4.22	21.18	-9.10	-0.27	1.20
Average Large Cap Blend Fund ‡	5.49	28.17	-5.53	0.46	0.01
U.S. Stock Market (Small Companies)					
Russell 2000 Index	3.88	27.17	-6.07	0.51	3.51
Dimensional U.S. Micro Cap Fund	2.58	28.06	-8.42	-1.17	6.30
Russell 2000 Growth Index	4.14	34.47	-4.00	0.87	-1.37
Russell 2000 Value Index	3.63	20.58	-8.22	-0.01	8.27
Average Small Cap Blend Fund ‡	4.64	31.80	-6.11	0.47	5.85
Real Estate					
DJ Wilshire REIT Index	9.18	28.46	-13.65	-0.07	10.67
Fixed Income (Bond) Markets					
BarCap Government Bond Index	-1.00	-2.20	6.10	4.87	6.17
Avg. Intermediate Gov't Bond Fund ‡	0.14	4.74	5.20	4.20	5.27
BarCap Municipal Bond Index	-0.96	12.91	4.41	4.32	5.75
Average California Intermed/Short Muni Bond ‡	-0.80	10.27	3.06	2.99	4.24
Credit Suisse High Yield Bond Index	6.24	54.22	5.33	5.99	7.08
Average High Yield Bond ‡	5.61	46.70	3.08	4.32	4.74
Citigroup World Gov't Bond Index	-1.93	2.55	8.06	4.51	6.63
Average World Bond Fund ‡	0.23	13.12	6.36	4.15	6.24
International Stocks					
MSCI EAFE Foreign Stock Index	2.18	31.78	-6.04	3.54	1.17
Average Foreign Large Blend Stock Fund ‡	2.64	31.24	-6.15	3.58	0.62
MSCI Europe Stock Index	3.24	35.83	-6.07	3.93	1.98
MSCI Pacific Stock Index	0.07	24.18	-5.97	2.73	-0.55
MSCI Emerging Mkt Index (excl. dividends)	8.25	74.50	2.73	12.79	7.29
Average Emerging Markets Fund ‡	7.59	73.81	2.21	13.24	9.02

‡ Source: Morningstar Principia 12/31/2009

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the MSCI emerging markets index is down 20.6%. During such periods of high volatility and steep losses investors feel the mathematics of investment return viscerally. While it takes just an 11.1% gain to recover from a 10% loss, a 33% gain is required to make up a 25% loss, and 100% to recover from a 50% loss.

Fixed Income Mixed

Last year's results from the fixed income market were mixed, depending largely on the credit quality of the issuer. Bonds issued by the US Treasury, which were bid up hugely during the credit crisis in 2008, fell between 3% and 13% last year (with the longer maturities falling farthest). As it began to seem that the economy had backed away from the abyss, the securities that suffered most in 2008, low rated high yield bonds, soared in value, with one Merrill Lynch high yield bond index returning 57.5% for the year. Junk bond yields fell from 24% in late 2008 to roughly 10% at year-end. Investment grade corporate bonds also performed well, with the average bond gaining more than 20%. The spread between highly rated corporate bonds and comparable Treasuries fell to 2% in 2009 from 6.25% a year before.

Real Estate: Occupancies Down, REITS Up

The commercial real estate market struggled last year as both rents and occupancies declined. As commercial loan portfolios began to collapse, many small and medium size banks did the same. Yet the return on securitized real estate, as measured by both the FTSE NAREIT Equity REIT Index and the MSCI US REIT Index, was approximately 28% in 2009.

The Best Stock of the Year

What large cap US stock did better than all the others last year? You might assume it would be Apple, which is reaping huge profits from its iPhone (+146.9%). Or, perhaps Amazon.com, which profited from a continued shift toward online shopping and excitement over the Kindle e-reader (+162.3%). Was it one of the larger mining outfits that are capitalizing on a resurgence in commodities prices, such as Freeport-McMoRan Copper & Gold (+228.5%)? In fact, the top performing large cap stock in 2009 was Ford Motor Company (+336.7%).

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Individual Country Returns 2009

	U.S. Dollar	Local Currency
North America		
United States	25.7	25.7
Canada	56.9	33.3
Latin America		
Brazil	127.1	69.8
Chile	88.8	50.3
Mexico	48.2	39.7
Africa		
South Africa	56.0	24.2
Europe		
Austria	55.6	50.7
Belgium	50.5	45.8
Denmark	40.8	36.4
Finland	17.5	13.8
France	28.6	24.6
Germany	24.1	20.2
Great Britain	39.5	24.2
Ireland	54.7	28.7
Italy	23.2	19.4
Netherlands	42.8	38.3
Norway	93.8	59.9
Portugal	35.4	31.2
Spain	32.6	28.5
Sweden	65.5	49.4
Switzerland	25.1	22.3
Asia		
Australia	70.9	32.5
Hong Kong	67.4	67.5
Indonesia	129.3	97.7
Japan	4.0	6.8
New Zealand	38.8	11.5
Philippines	70.4	65.6
Singapore	74.0	69.6
South Korea	65.3	52.9
Taiwan	83.1	78.4
Thailand	71.7	64.6

Source: Dow Jones Global Indexes