The Financial Navigator – January Newsletter

Happy 2011, in this month's newsletter I wanted to touch on the 2011 payroll tax holiday which will give us all a raise, on a little know rule concerning Roth IRA conversions, and comment on 2010. Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Payroll Tax Decrease – Your 2011 'Raise'

Last month's tax deal to extend the 'Bush Tax Cuts' two more years included a 2% decrease in payroll (Social Security) taxes; however it is just for 2011. The payroll tax in 2011 is reduced for employees from 6.2 % to 4.2 %; note employers will still have to pay their 6.2 %. In effect, we all just got a raise courtesy of Uncle Sam. If you make at least the $106,800 that is the maximum earnings subject to the payroll tax, your 2011 take home pay will be $2,136 higher compared to 2010. For high earner couples, that's another $4,000 plus of disposable income at your fingertips. For a typical worker, with taxable income of about $50,000 a year, the payroll tax holiday means a $1,000 bump over the course of the year.

Now you may be asking: But I thought Social Security is going broke, why are we reducing its funding? Great point, the last annual report from the Social Security and Medicare Boards of Trustees accelerated the arrival of the insolvency of Social Security trust funds by four years to 2037. This payroll tax deduction can only exacerbate that situation to some degree, but Washington DC has determined that the stimulative impact of this extra money in the public's pocket is worth the risk.

The $120 billion (the reported cost of the payroll tax holiday) question is: What are you going to do with that extra money? One consideration might be to ensure you max out your 401k/403b plan contribution if you aren't doing so already. You won't even notice contributing that 2% directly into your plan as your paycheck will see no impact. With Washington intent on avoiding the looming Social Security deficit, you can be sure you will be funding most of your retirement through that workplace plan; any contributions now can only help.

Roth IRA Conversions 'Undo'

Investors who converted a traditional IRA to a Roth IRA in 2010, but begin to regret it later in 2011, have until October 15th to reverse the move and get back any taxes they paid under a little known IRS rule. Roth IRAs have some benefits over traditional IRAs such as tax-free growth and withdrawals, but they are not for everyone. If your financial circumstances have changed – or if the value of your Roth IRA has declined substantially – it may benefit you to undo, or *recharacterize*, your Roth conversion.

The key point about a Roth IRA conversion is that you pay taxes up front on the amount you convert as that amount is added to your taxable income for the year of the conversion. As mentioned above, one reason to regret a conversion is if the value of your new Roth declines significantly. For example say in 2010 you converted an IRA worth $100,000 and pay the tax bill in April 2011. But in August you now find your Roth IRA to be worth just $75,000. The smart move would be to *recharacterize* the Roth conversion, essentially move the money back to the IRA it came from, and get back the taxes you paid. But remember, you must recharacterize the Roth conversion by October 15th of 2011.

Thoughts on 2010

As we reflect on 2010, I'm writing to share some thoughts on today's economic outlook and the current psychology among many investors, reflected in the quote below from Winston Churchill.

"The pessimist sees difficulty in every opportunity. The optimist sees opportunity in every difficulty." - *Sir Winston Churchill*

First a summary of stock market performance in 2010. It's a cliché to describe the stock market as a roller coaster ... but sometimes clichés are rooted in reality. Stock markets over the past couple of years have seen extreme swings, something that continued this year. Here's how markets have performed in 2010. Note the strong recovery after a first half that was challenged by the Greek debt crisis and BP oil spill.

	Six months to June 30	**12 months to Dec. 31**
US	-6.5%	+15.6%
Developed Foreign	-14.7%	+4.9%
Emerging Markets	-7.2%	+16.4%

Source: MSCI index. All returns are in local currency

Today's pessimistic mood

Today we're seeing a mood of widespread fear and pessimism, as many investors feel overwhelmed by problems in the US, led by high unemployment, Government deficits, depressed housing prices and gridlock in Washington. Look to Europe and you've got many of the same challenges, as well as banking problems in Greece and Ireland, with Spain and Italy rumored to follow.

Throughout history people have regularly overcome problems of similar and bigger magnitude. This is one of the themes of a thought-provoking new book by leading science writer Matt Ridley - *The Rational Optimist: How Prosperity Evolves*. In it, Ridley makes the case for optimism about the future. In a review of this book by Bill Gates that ran in the *Wall Street Journal*, Gates points out that Ridley documents constant predictions of a bleak future throughout human history.

For example, Reverend Thomas Malthus, a contemporary of economist Adam Smith in the late 1700s wrote that increasing population would arrest advances in the quality of life. In the 1960s you had Paul Erlich's bestselling book, *The Population Bomb*, and in 1972 *The Limits to Growth* was published by the Club of Rome; these both posited that increasing population and finite resources would cap our ability to grow and to support the world's population.

It's not that these weren't real issues – but they were blown out of proportion. As Bill Gates writes:

“Despite these problems, our lives have improved dramatically in terms of lifespan, nutrition, literacy, wealth and almost any other measure you'd care to name.“

Perhaps a worthy point of view in light of the constant media focus on worldwide debt, global warming, SARs, underwear bombers, and the BP Oil spill to name just a few of the latest litany of life threatening crises.

The role of innovation

There are at least two reasons to be optimistic for the mid term– the role of innovation and some of the incredibly positive things that are happening in emerging economies in Asia, Latin America, Eastern Europe and even Africa. With regard to innovation, in his review of Ridley’s book, Bill Gates wrote:

“Pessimism is so often wrong because people assume a world where there is no change or innovation. They simply extrapolate from what is going on today, failing to recognize the new developments and insights that might alter current trends.”

Today, we’re continuing to see record spending on innovation around the world. Countries like China and India are making massive investments in research and development. In fact, next year China is expected to trail only the U.S. in the number of patents filed, truly remarkable when you consider that 20 years ago it had no history of protection of intellectual property.

The other big positive is what’s happening in emerging economies. People who return from China and India talk about being blown away by the drive, energy and ambition they see there. You’ve got a new middle class that wants a better life and you’ve got a whole new generation of incredibly talented young people who are getting educated, applying a strong work ethic and making a huge impact as a result. China and India are forecast to continue growing by 8 to 10%; you’re also seeing strong growth from other countries like Brazil, Turkey and Indonesia.

This is not to say that these countries aren’t facing challenges of their own – there’s a big difference between being a rational optimist and a blind optimist. Emerging economies have huge infrastructure issues to address. They’ve got big disparities between incomes in cities and in rural areas that are causing tensions. In some cases, they’ve got mini real estate and housing bubbles. But they key is that there’s no reason to believe they won’t work through these.

What this means for the West

Thinking back to Winston Churchill’s comment, pessimists read about China, India and other developing countries and conclude that they’re going to achieve growth at the expense of Western countries, and all those super-bright, super-ambitious young kids are going to eat our lunch.

While this could in theory take place, it doesn’t have to happen. Many western companies are well positioned to capitalize on the growing middle class in developing economies. A rising percentage of revenue and profits from top consumer goods firms like BMW, Procter and Gamble, Nike, Apple, Nestle and McDonalds are coming from these emerging countries – more and more the key to success for western companies is operating globally. The good news is that these multinationals not only have strong brands but also strong balance sheets. *Western consumers and governments may be stretched financially but companies have record levels of cash and are in good shape financially.*

As for the argument that these emerging economies are going to win at our expense, this example of the scarcity mentality assumes that the size of the wealth pie we're dividing up is fixed. It's not – through trade and globalization, those emerging markets are going to dramatically increase the amount of wealth in the world.

It also assumes that western economies and companies won't adapt. Early economist wrote about something called creative destruction – how the process of innovation in open markets transforms economies, destroying old business models and jobs, replacing them with new ones. This is the essence of how open markets work. It's messy and very painful if you're caught in the middle of this transition, but in spite of that, it's still far and away the best model for running an economy. If you don't believe this, ask yourself if we'd be better off if China and India were closed economies, like they were in the 1980s, or if communism or socialism offers a better solution. It's simply impossible to make that case.

Implications for investors

First, understand how much volatility you can tolerate. There's no reason to believe that markets won't continue to be highly volatile as they have been during the most recent past. With every client, we work through how much short term volatility and risk they can withstand. For retired clients, I advise setting aside three years of cash needs from savings in safe liquid investments, something that can reduce stress in volatile markets.

Second, we need to take a "rationally optimistic" view of the future, walking the fine line between succumbing to dire pessimism on the one hand and blind optimism on the other. This will not necessarily pay off in the next six or even 12 months – but history tells us that we'll ultimately be very well rewarded for investing in the companies and markets best positioned for the future.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.