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I. 2010 A Year of Uncertainty in Estate Taxation:

There are two big changes to federal estate taxation this year: (1) for 2010 only there is NO FEDERAL ESTATE TAX, and (2) accounting for assets inherited this year will be significantly more difficult than in the past. Here are a couple of excerpts from a memorandum, recently received, from a local family law firm on the subject:

"First, it is important to determine whether your estate plan should be amended in order to ensure that your primary goals are accomplished if you should die during 2010. Wills or trusts that refer to the marital deduction, the federal estate tax, the unified credit, the estate tax exclusion amount, and/or the generation-skipping transfer tax should be reviewed promptly, because it may not be clear how a court would interpret a will driven by tax concepts that aren't effective during 2010.

[T]he tradeoff for repeal of the estate tax for individuals dying in 2010 is that beneficiaries of their estates will not have the income tax cost basis of assets adjusted (usually increased) to the value as of date of death. In other words, built-in capital gains will be passed along to beneficiaries and no longer forgiven at death. … You should not be in any hurry to throw away financial records, since the factual investigations necessary to determine your cost basis of property held for many years will be impossible without such records. If your beneficiaries can't prove what you paid for an asset, the law effective in 2010 assumes your basis was zero, subjecting the full value of appreciated assets to capital gain tax when your beneficiaries sell."

Smartt Comment: I don't often rail against Congress and its members, (I had an uncle in Congress may years ago and I saw first hand how hard he worked and how difficult it was for him to get away from his work). For years legal and accounting professionals have had an expectation that Congress would act and that this would not become an issue, let alone the mess described above. If you need a referral to an estate/trust attorney, do not hesitate to contact me.

II. What Are OUR and THEIR Asset Allocations?:

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of March 31, 2010	Clients	The Smartts
Money Market Funds	1.8%	1.4%
Bond Funds	31.3%	3.4%
Stock Funds	66.9%	95.2%

Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family.

III. Vanguard Rates of Return (through March 31, 2010):

Performance percentages are per ***Morningstar.*** Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended March 31, 2010	Yr.-to-date		5 Years		10 Years	
Total Stock Market Index	**6.0%**	(17)	**2.6%**	(30)	**-0.1%**	(45)
Tax-Managed Capital Appreciation	**5.7%**	(22)	**2.5%**	(34)	**-1.2%**	(75)
Tax-Managed Small Capitalization	**8.6%**	(39)	**3.6%**	(41)	**6.7%**	(42)
REIT Index	**10.0%**	(33)	**3.8%**	(39)	**11.0%**	(37)
Tax-Managed International	**1.2%**	(41)	**4.0%**	(44)	**1.4%**	(38)
Balanced Index	**4.3%**	(21)	**4.1%**	(27)	**2.7%**	(40)
Total Bond Market Index	**1.7%**	(83)	**5.4%**	(32)	**6.0%**	(34)
Interim-Term Investment-Grade Bond	**3.4%**	(14)	**5.4%**	(30)	**6.5%**	(14)
High–Yield Corporate Bond	**3.6%**	(68)	**5.6%**	(66)	**5.6%**	(56)

For comparison, here are several stock and bond benchmarks:

Periods ended March 31, 2010	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	**5.4%**	**1.9%**	**-0.7%**
Russell 2000 (small stocks)	**8.9%**	**3.4%**	**3.7%**
MSCI EAFE Index	**0.9%**	**3.8%**	**1.3%**
Barclays Aggregate Bond Index	**1.8%**	**5.4%**	**6.3%**
CS First Boston High-Yield Index (bonds)	**4.5%**	**7.2%**	**7.7%**

Vanguard mutual funds and ETFs continue to perform as expected.

The MSCI EAFE Index, added to the benchmarks section above, and added to client's quarter ending reports at last year end, is designed to measure the equity [stock] market performance of developed markets, excluding the US and Canada. It consists of 21 developed market countries indices, including, Australia, France, Germany, Hong Kong, Italy, Japan, Sweden and the United Kingdom. It is a reasonably good fit for the Tax-Managed International fund owned by many clients.

Note that the rates of return for the Vanguard mutual funds in the table above are for the regular class of the fund. E.g. the Total Bond Market Index fund results included are for the regular, investor class fund which has annual operating costs of 20/100%. (Most clients own, instead, the ETF version of the same fund with annual cost of 10/100%--half as much cost.) The Total Stock Market Index fund above has operating costs of 16/100%, but "VTI" the ETF version of the fund has costs of only 7/100%. Thus most clients, through ownership of the lower cost version, earned slightly higher rates of return. Such slight savings in cost compound/multiply as the years roll on. Small differences in operating cost are expected to earn large differences in total investment value over long periods of years.

For some investors there are reasons to continue to own the investor, (higher-cost)class of these funds rather than the ETFs. First, the fund may have increased significantly in value since the purchase and be owned within a regular, currently taxed account. Sale of the fund and purchase of the ETF might cause a taxable capital gain levy. Second, to change from the mutual fund to the ETF costs brokerage commissions, and such commissions, in relation to small holdings, may be high enough to wipe out projected mutual fund cost savings.

I'd be pleased to discuss your situation with you further.

IV. <u>The Best Shall Be Worst</u>:

The following is a section of the book: <u>The Big Investment Lie</u> (How to be A Smart Investor—and Stop Throwing Your Money Away, What Your Financial Advisor *Doesn't* Want You to Know):

"A striking example of the point that past performance does not predict future performance is a story in the July 11, 2003, issue of *The Economist. The Economist's* story relates to the astonishing fact that the top ten mutual funds for the three years from the end of 1996 to the end of 1999 were all among the *worst*-performing 7 percent of mutual funds for the next three years.

If you had invested at the beginning of 2000 in the top ten performers of the previous three years, you would have experienced a brutal come-uppance. In the next three years, you would have lost 70 percent of your investment. Many investors did this—a large proportion of them on the advice of professional investment counselors.

It is not really typical that the best performers in the past actually become the *worst* in the future. Statistically, it is more typical that half the best past performers become better than average and half become worse than average. But the overall lesson is simple, if counterintuitive: past performance is *definitely not* a predictor of future investment performance.

I am not saying that professional money managers are not smart or knowledgeable people. They are usually well educated. They try to keep themselves well informed about the economy, market sectors, technologies, and current public affairs. This doesn't mean that they can predict the market or the price of stocks."

Smartt Comment: First, the only mutual fund historical data which may be predictive are: (a) level of mutual fund cost, (b) rate of portfolio turnover (another cost), and (c) degree of diversification. Past performance is, if anything, a negative indicator since the rates of investment return of most investments move back toward average (the statistical term is "regression to the mean"). No one can predict the future, so my approach is to (A) diversify broadly, (B) minimize investment costs and (C) place assets in specific accounts in order to reduce or delay income taxes.

V. <u>15 Roth IRA Conversion Traps:</u>

Ed Slott, CPA, has a national reputation as an author and lecturer on the subject of IRAs. Back in February at the TDAmeritrade conference in Orlando, I heard him speak on this subject. Here is his list of potential Roth conversion (change in form from a regular or traditional IRA to a Roth IRA) traps.

1. New Roth accounts need new beneficiaries
2. On a 2010 conversion, the income is split, not the tax

3. 60-day rollover mistakes
4. Partial conversions involving after-tax money—the pro-rata rule
5. Rolling to an IRA mid-year—the pro-rata rule
6. Required Minimum Distributions must be taken first
7. Some funds are not eligible for conversion or contribution
8. Non-spouse beneficiaries can't convert inherited IRAs
9. SIMPLE IRA 25% penalty
10. The 10% penalty trap
11. Loss of credits, exemptions, deductions and more
12. Medicare costs and Social Security taxation
13. Financial aid loss
14. Net unrealized appreciation
15. Not using separate new Roth IRAs

In a general introduction article last issue I provided general background on the subject of Roth IRA conversions and suggested that you consult your tax preparor/counsel regarding the advisability, noting that I would be pleased to work with you and that person the determine whether and how a Roth conversion might benefit you.

As the list above shows, this is a complicated process. It is a potential, significant tax benefit to many. If you believe you might benefit, I'd be pleased to discuss this with you and your tax advisor.

VI. Books About the Financial Crisis

I recommend John Lanchester's I.O.U.—Why Everyone Owes Everyone and No One Can Pay. It is a comprehensive explanation of the financial crisis and is the least technical of the books I have found. The author writes for the *New Yorker* and the *London Review of Books*. To date I have finished seven other books about the crisis, all more complicated and less comprehensive. The only defect of the Lanchester book is that he occasionally speaks more about the British economy than might be of interest to a US reader/investor. If you like financial non-fiction, this is a good time to be a reader. Here are the others I have completed:

The Big Short by Michael Lewis (stories of the few investors who got the mortgage mess right)
No One Would Listen—A True Financial Thriller by Harry Markopolos (Madoff whistleblower)
The Foreclosure of America by Adam Michaelson (insider description of Countrywide Mortgage)
The Greatest Trade Ever by Gregory Zuckerman (more right-thinking mortgage investors)
How Markets Fail by John Cassidy (economic thought's contribution to the crisis)
Too Big to Fail by Andrew R. Sorkin (the Lehman Bros. crisis and the US Govt.'s response)
House of Cards by William D. Cohen (the fall of Bear Stearns)

I'm currently reading a history of the AIG insurance company. I support efforts to rein in Wall Street and the banks and to protect investors.

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