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"A social economic right created by government to benefit one citizen by placing a financial obligation unwillingly on another is neither life, nor liberty, nor happiness. It is tyranny."

- Steve Schatz, *Letters to the Editor* 4/26/12, *Wall Street Journal*

Tax and Financial Strategies

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WEALTH CREATION STRATEGIES

Dear Doug: The Pros, Cons and Other Features of Annuities

Dear Doug,

I'm considering using my \$200,000 in savings to purchase an annuity. I'll probably begin taking payouts in two years, when I intend to retire. What are the pros and cons?

Signed,

Looking for longevity insurance

Dear Looking,

First, let's make sure you understand what an annuity is. Types of annuities are typically categorized by start dates: immediate or deferred. They are further separated by the type of payment you receive, fixed or variable.

I believe this classification is less than helpful and suggest categorizing them based on their most important attribute: durability. I'd call one an "income" annuity, in which you receive a monthly income lasting for as long as you live, which ends at death. The insurer benefits if you die young; you benefit if you live long. I'd call the other a "survivor's" annuity, in which you decide to take withdrawals, or not—and whatever hasn't been withdrawn at death is left to heirs. While its key use is income (and therefore tax) deferral, it can be converted to the first type at any time during your life.

There are innumerable variations of these two types, including fixed vs. variable payout amounts, when payments end (at your death, your spouse's death, 10-year guarantee even if you die

earlier, etc.) and even inflation-indexed payments. Annuities can be incredibly complex and require far greater analysis on a case by case basis than what follows; be sure to see us (*before* you purchase) for specific questions. There are huge differences in terms of costs and benefits of annuities offered by different companies and even different types of annuities offered by the same company.

In general, on the positive side:

1. Annuities can buy a lifetime guarantee of income, which can help protect you from running out of money. This can be especially helpful for those who have a tough time controlling their spending.
2. There are many options from which to choose, including inflation protection, joint and survivor (where payments continue for the longer lived of you or your spouse), guaranteed death benefit of some amount (so it doesn't all go "poof!" when you die, like Social Security does), countless ways to invest the funds inside the annuity, etc.
3. In exchange for a promise to leave the bulk of the funds with the insurance company for an extended period, you *could* be paid substantially more

than you would earn on a CD (even if not necessarily true in today's market climate).

4. As long as you don't withdraw any of the funds, earnings are not taxable. As you will see, while this can work in your favor it can also be detrimental to your financial health.
5. You can invest any amount you wish, which is not true for qualified retirement plans such as IRAs, 401-k's, etc.

On the other hand, here are some of the negatives:

1. Annuities can be very expensive due to large sales commissions, annual account fees and insurance company up-front charges. As a result, while the annuity company may claim to pay an attractive return *on* your investment, often this rate applies only once you annuitize—when they pay earnings on your investment as well as return the investment itself (bearing in mind that when you annuitize, the money is gone when you die). This effectively lowers the *real* return, often to a level below what you can earn on short-term corporate bonds and even CDs.
2. Withdrawals greater than an allowed monthly amount can-

not easily be made without substantial penalties called “surrender charges,” which vary tremendously by policy and from company to company. The reason for these high surrender charges, which can cost many times the “early withdrawal” penalties banks charge for CDs, are the very high sales costs commonly associated with annuities. The salesman is paid when you purchase, so you essentially pay the commission to get out of the annuity early. In addition, there can be hidden surrender charges in the form of a reduced return on your investment (and even claw-backs of what you’ve already “earned”) when you fail to annuitize.

3. Disproportionately large commissions tend to cloud the judgment of those pushing selling annuities. They may not be appropriate, but come right in little girl, I have a lollipop for you.
4. Because their features vary so much from company to company and even within the same company, and companies play so many games with advertised vs. actual returns, annuities can be very complex to analyze and compare.
5. You could tie up a large chunk of change, unable to easily access your funds in an emergency.
6. Buying a large annuity could result in inadequate diversification.
7. The cost of inflation protection, if elected, is high. For the same initial cost of an income annuity, you will substantially decrease your permanent monthly income. Depending on age and other factors you might, for example, select a fixed payment of \$1,000 per month for the rest of your life, or an inflation-indexed one that starts at a much lower

amount, \$770 for one company we experimented with based on a 66-year-old annuitant. On the other hand, future inflation may greatly diminish the value of a non-inflation indexed annuity.

8. Since expected returns for fixed income annuities are so low in the current climate of low interest rates, you may benefit by waiting to purchase such an annuity when rates are higher. On the other hand, low inflation expectations may lower the current cost of purchasing an inflation-protected annuity.
9. “Income” annuities (those that end when you die) don’t work very well for those who die young. Keep in mind, insurers are not stupid and are well aware of “adverse selection” in which, generally, only the most long-lived people purchase annuities that have zero value at death. Therefore, such annuities are a better deal for those who expect to live long lives.
10. Earnings from variable annuities, which hold securities that would otherwise be eligible for long-term capital gain treatment, are taxed as ordinary income when withdrawn. In other words, annuities (just like retirement accounts) convert long-term gains with (currently) tax-favored treatment into ordinary income. The same is true for currently tax-favored dividends.
11. If an annuity comprises the bulk of the assets of an IRA, you may have great difficulty doing Roth conversions. Even if you are able to do Roth conversions, it may be impossible to “undo” any conversions that are subject to higher-than-desirable tax rates (“partial re-characterizations”).
12. For annuities held outside IRAs and other retirement ac-

counts (i.e., “non-qualified annuities”), income deferral often works against the taxpayer. I’ve seen numerous cases over the years in which clients should have been taking yearly withdrawals, on which little or no tax would have been paid. Instead, earnings were allowed to build up, a substantial amount of which was withdrawn all in one year. Not only was the amount withdrawn subject to much higher tax rates than necessary, but also because income was greater, more Social Security benefits were taxed, much or all of which would have been tax-free had the earnings been withdrawn yearly. I’ve seen other cases in which the annuitant died, leaving the “survivor” annuity and its tax effects to well-off children, largely if not completely defeating the tax advantage of the annuity. The annuity owner could have taken more withdrawals at low tax rates, leaving a larger previously-taxed inheritance; instead, the heirs paid tax on annuity earnings at their much higher tax brackets.

13. You already have one mandatory “income” annuity called Social Security (Ponzi scheme though it is), which is indexed for inflation. Do you really need another annuity?

Additional factors to consider when purchasing annuities:

1. The present value of your Social Security “income” annuity. This is in the range of \$150,000 to \$350,000 for most people at age 66.
2. The relative size of other investments in your overall portfolio. If all you’ve got is Social Security and \$200,000, tying up that \$200,000 in an annuity leaves you woefully undiversified and illiquid in case of emergency.
3. If the \$200,000 is inside an

IRA or other pension, comment # 11 above needs to be carefully considered. You do NOT want to tie up all of your pre-tax retirement account in an annuity, which is difficult and even impossible to convert to a Roth IRA. We have a number of clients whose funds are completely frozen in this regard and are unable to do conversions, despite the fact that they would greatly benefit by doing so (their tax rates are temporarily low).

My chief objections to annuities are important enough to re-emphasize and summarize:

1. Their extraordinary inflexibility, especially in regards to Roth conversions and recharacterizations.
2. The lack of inexpensive inflation indexing.
3. The imposition of steep penalties for early withdrawal of more than an “allowed”

amount. Both penalties and allowed withdrawals vary greatly depending on the annuity.

4. The tax-free build-up of earnings in non-qualified annuities, which often works against elderly clients in low tax brackets.
5. Long-term capital gains and qualifying dividends held in annuities are treated as ordinary income upon withdrawal. This is the only one of these objections that also applies to IRAs and other retirement plans on which tax is deferred; however, in itself this is not a strong enough objection to argue against investing in non-annuity retirement plans for those in high-enough tax brackets.
6. Those who sell annuities are often not the most forthright. I wrote an exposé of Doug Andrews’ horrifically misleading work, *Missed Fortune 101*, which focuses on a particular life in-

surance product. However, the ideas are applicable to annuities—so much so that many annuity salesmen hawk his work and books. Take a look at my review of this particular book at <http://preventragedy.com/pages/bookreviews.html> or the abbreviated version at the book’s listing on Amazon (<http://www.amazon.com/Missed-Fortune-101-Becoming-Millionaire/dp/0446576573>), where my review is still at the top under “most helpful customer reviews,” to get a glimmer of how awful it is.

All this is not to say there aren’t some uses for annuities. However, they should, I believe, *generally* be just one part (if any) of a retirement portfolio. And keep in mind nearly all of us already have one annuity: Social Security. I need some really good reasons to add substantially to that one.

Dear Doug: Should I Contribute to an IRA, a Roth IRA or a 401-k? I’m in a High Tax Bracket.

Dear Doug,

Despite recently buying a home, a “chunk” of our income is taxed at 25%. We want to begin investing in our retirement, but are confused over the type(s) of retirement account(s) to contribute to. What do you recommend?

Signed,

Confused investors

Dear Confused,

This is a complex question, which depends on your goals and particular needs. Without knowing a lot more about you and your situation, I can only offer some general advice.

First, you should invest in your company’s 401-k to the extent your employer matches contributions. If they match 50% of your contributions up to, say, 6%, then you should invest

at least 6%. It’s a no-brainer because for every \$1,000 contributed (up to that 6%), your employer adds \$500 extra at no cost to you. Your tax savings is 25% federal plus 9% CA state, which lopped \$340 off your tax bill. Your net cost, then, for a (\$1,000 self-contribution plus \$500 employer match =) \$1,500 investment is only \$660. Your immediate return on this contribution is 134% (\$1,500 divided by \$660). Where else are you going to get an initial return of that magnitude? For that matter, even if you were still in the 15% bracket with no state income tax, your net cost of \$850 (\$1,000 less \$150 in tax savings) is well worth the result.

Second, you are ineligible for deductible traditional IRAs if you and your spouse have company plans (401-k’s or other retirement plan) available, even if you don’t contribute to such a

plan. If your spouse does not have such a plan through his employer and your combined total income is less than phase-out levels (roughly \$167,000 to \$177,000 for married filers), the spouse can invest in a traditional deductible IRA. In this case, the spouse with the 401-k should first max out to the extent that employer matching contributions are made. Then, depending on other needs, availability of funds and personal preferences, additional contributions can be made either to his 401-k or your traditional IRA.

(As an aside, assuming you cannot max out on both 401-k’s and IRAs, there are at least two non-tax considerations in deciding which retirement plan to allocate funds to. First, IRAs offer greater flexibility in terms of investment vehicles, such as stocks, mutual funds, bonds, etc., than do 401-k’s.

Second, while you cannot borrow from IRAs, you can borrow tax- and penalty-free from 401-k's under certain circumstances. We've had two clients who are saving to purchase a home, for whom maximum 401-k contributions make great sense—part of their down payment may come from borrowing out of the 401-k.)

Third, if you expect to remain in high tax brackets for the rest of your lives and other funds are available to cover living expenses, Roth IRAs can make sense. The end result of investing \$10,000 into traditional IRAs or other tax-deferred retirement accounts is mathematically equal to investing the after-tax funds of \$6,600 into Roth

IRAs, assuming the same 34% combined federal and state tax bracket applies for the entirety of one's life. However, bear in mind (1) tax laws and rates will not always remain the same as they are now, (2) you may move to a lower- or no-tax state at some point—why pay tax now at 34% if you can pay tax later at 25%? and (3) if you have additional after-tax funds available, investing \$10,000 into a Roth is worth a lot more than \$10,000 into pre-tax retirement accounts (again assuming the tax bracket remains the same now and later). The combinations and permutations of personal situations are seemingly infinite, so what may be appropriate for others may not be appropriate for you.

For example, there are many uses for Roth IRAs other than retirement. Since withdrawals of contributions can be made at any time without tax or penalty, clients have used them for emergency reserves, college education for their children and at least part of a down payment on a home. Needless to say, this is an area of planning for which our counsel is worth seeking because of the complexity and constant changes of law, availability of multiple options and huge variations in individual circumstances. When it comes to retirement and other financial planning, one size does *not* fit all.

CP2000 IRS Computer-Generated Love Letters: Many are Just Plain Wrong

We are in the vanguard in educating clients why Roth conversions are so beneficial. As a result, we are way ahead of most other advisers in getting educated clients to actually consummate Roth conversions when appropriate for their particular situation, which is generally for clients who can pay tax now at lower rates on retirement funds than they will be subjected to later. Since we often “over-do” conversions with the goal of ensuring we “use up” every last inch of the lower tax bracket that we deem desirable for the particular client, we may do more partial “recharacterizations” (“undoing” of some part of those conversions—keeping in mind tax is paid only on the “net” conversion after any recharacterization) than any other practitioner in the country as a percentage of the client base. As a result, our clients have become recipients of more CP2000 letters from the IRS than clients of other practitioners. These letters, which assume the entire conversion is taxable (wrong!) propose additional tax, penalties and interest.

The incompetence on the part of IRS computer programmers is breathtaking. The system has apparently not been programmed to wait for reports of partial or complete recharacteriza-

tions of prior year Roth conversions (1099s were received in early 2012 for 2011 recharacterizations of 2010 conversions). It's possible the system hasn't even been programmed to *look* for such recharacterizations. The ineptitude extends to those designing forms. The “conversion” form, Form 8606, asks for one number: conversions NET of recharacterizations, rather than *both* numbers. So, if you convert \$20,000 and “undo” \$5,000 of that conversion the following year, all the IRS sees is a \$15,000 (net) conversion on your tax return and a 1099 for \$20,000, resulting in a mismatch in their system and an audit letter, proposing tax, penalty and interest on the \$5,000 they think you omitted. If you undo the entire enchilada, they don't even see the form, since forms cannot be e-filed that show “zero,” the taxable amount of any conversion that has been completely recharacterized.

Many of the conversions and recharacterizations are being made by elderly clients. Can you imagine being in your 70s or 80s, or even 91 years of age (as one client was) and getting that yellow envelope from the IRS tentatively imposing additional tax of \$2,000 or \$20,000, plus penalties and interest?

Worse, CP2000s are also being

issued for rollovers from IRAs and other pension plans to other retirement plans, most commonly from one IRA to another. Some audit notices are questioning indirect rollovers, in which funds are withdrawn from one IRA and deposited into another IRA within 60 days. Since you might spend the money or miss the 60-day window, a CP2000 letter is somewhat understandable. However, proposed assessments are also being issued for direct rollovers, where IRA custodians send the retirement funds directly to another IRA custodian—for which the IRS should have received a report (discussed below).

Despite our attempts since at least the early 2000s to educate clients as to why conversions make sense, most eligible clients didn't begin doing them until 2008. The returns for 2008 were prepared in 2009 and the notices started coming in 2010. It began with a trickle: there were only two such letters in 2010. But for 2009 returns with notices received in 2011, there were six for unrecognized partial or total recharacterizations of Roth conversions, along with one for an indirect rollover and, incredibly, two for direct rollovers. For 2010 returns, the letters have turned into a torrent; at press time,

We've received eight for unrecognized recharacterizations, two for indirect rollovers and two for direct rollovers (and we're only five months into the year).

Needless to say, we haven't lost and won't lose any such audits. They are a complete waste of taxpayer resources, our time (for which we do not charge additional fees) and our clients' time. Worse, they can be unnerving for our clients, especially some of the elderly ones.

So, what do you think your favorite Enrolled Agent would do?

If you think he might begin a campaign to stop this nonsense, you would be correct!

When the number of "recharacterization" letters ballooned from just a few through April 15 to eight by the end of April, I sent an

email to the government affairs liaison at the National Association of Enrolled Agents in which I attached several examples of responses to IRS letters for which explanations should never have been necessary (with pertinent client information obviously blocked out). I recommended that Form 8606 be changed to clearly reflect both the original conversion (shown on the 1099 for the year in question) and the recharacterized amount (shown on the 1099 with code "R" in the year following the conversion). I followed it up with another email in which I suggested that the IRS wait to send letters until the recharacterizations clearly show up in their system, which I would expect to be May or June (assuming they *ever* show up).

This doesn't explain CP2000s for direct rollovers. 1099s reporting such

rollovers are coded "G" for "direct rollover," which the IRS even acknowledges in their CP2000 letters. Despite this clear categorization, a letter with proposed assessment is issued, one of which was for about \$50,000 in additional tax, penalties and interest for a direct rollover of nearly \$150,000. Nor does this explain indirect rollovers, for which the tax return itself says "ROLLOVER" next to the line on which pensions and IRAs are reported. I also mentioned these issues to the government affairs liaison in my letter to him.

Hopefully, next year's Form 8606 will have the "Designed by Doug Thorburn" imprint on it and these letters will stop, so you can do future conversions in more peaceful coexistence with the IRS.

Confusion Reigns over Roth Conversions

Two years after writing what may be the most complete summary of Roth conversions anywhere, including debunking numerous myths of Roth IRAs frequently expounded by bankers and brokers who should know better, confusion still reigns. Here are just a few of those we heard this Season. (For a much more complete exposition of such myths, please re-read issue # 40 of *Wealth Creation Strategies*.)

1. "You're too old to do a Roth conversion."

We asked a mature client in a high tax bracket with plenty of available non-retirement funds why he withdrew so much more out of his traditional IRAs than was required. He responded, "I don't want my kids to have to pay taxes on this money." After checking my prior year notes to be sure I had already suggested that he do a Roth

conversion (I had), I asked why he didn't do it. Because, he said, the banker told him he was too old. I suggested the next time bankers or brokers disagree with my advice (or tell him anything else questionable) that he call me from their offices. I also told him what I'd like to do to that banker.

2. "Why not wait to do Roth conversions until she's 59 1/2?"

We suggested a series of conversions for a client, age 56, who has little income but about \$30,000 in an IRA and \$200,000 in a taxable investment account. The suggestion involved converting just enough each year—about \$5,000—to "use up" the zero tax bracket for each of several years.

Her broker told her not to do the conversion. When I spoke with him on the phone he asked, "Why not wait until she's 59 1/2?" I responded,

"Because she won't pay any tax by doing it now." He said, "She'll pay a penalty!" I explained there are no penalties on conversions. "But," he argued, "she won't pay any tax by doing it later!" I retorted, "How do you know? Her circumstances, rates of return, etc. may change by then." Good thing he wasn't sitting in front of me. This went on for fifteen minutes before he finally acquiesced to the idea that we may as well take advantage of a zero tax bracket.

The broker didn't know the client's tax situation or the law. He didn't grasp the idea that we should *always* take advantage of a zero (or, if appropriate, a relatively low) tax bracket when the opportunity arises, especially if any tax on conversions can be paid from non-retirement funds. In such situations, there is *never* a reason to wait to convert.

Dear Doug: When Can I Spend the Money in the Roth IRAs Created From My Conversions?

Dear Doug,
Over the years, I've taken your advice and converted a lot of IRAs into Roth

IRAs. My question, is, now that I'm retired, when can I spend the money that's sitting in those Roth accounts?

Signed,
Itching to go have fun

Dear Itching,

The answer is different for those under 59 ½ and those over 59 ½. Just a quick comment for those younger than that crucial threshold: if you want to avoid paying penalties on withdrawals, you generally must wait until you are 59 ½ (although there is an interesting loophole for you younger folks, which I won't get into here).

Now let's address your situation. You're over 59 ½, so you can withdraw the converted funds and go have fun with them at any time. However, if you want to avoid paying tax on earnings, you must let the earnings from each conversion ride for five years. That's simple and easy enough, especially since whatever you withdraw from Roth IRAs is deemed to come first from contributions, then from conversions, next from earnings on contributions and last from earnings on conversions. Short of withdrawing the whole wad, you're unlikely to ever come close to having to pay tax on the earnings. On the other hand, if you withdraw the principal *and* some or all of the interest, you'll have a bit of a bookkeeping nightmare on your hands. Try and avoid that, would you?

The more important question is which funds should you use first to have fun: those in traditional IRAs, Roth IRAs or non-retirement accounts? My general advice is to use

Roth funds only when:

1. You run out of money in non-retirement accounts
2. You have used up your low tax brackets by taking withdrawals from traditional IRAs

Let's say you have \$300,000 in traditional IRAs, \$100,000 in Roth IRAs and \$200,000 in non-retirement accounts. You should withdraw enough from your traditional IRAs to "use up" your lowest tax brackets (likely zero, 10% and 15%) and then withdraw from your taxable accounts (assuming there are no capital gains created by taking such withdrawals; if there are, we should further analyze the relative tax costs before making a decision). Only when taxable account funds have all been spent should you begin withdrawing from your Roth IRAs.

Many people cringe at the idea of using up all their non-retirement funds, but they shouldn't. They are missing a crucial concept: money in a Roth IRA to the extent of contributions is, for personal spending needs, just like any other money in the bank. Contributions can be withdrawn at any time without tax or penalty. The same is true of converted funds once you are 59 ½, earnings on *contributions* for those over 59 ½ if your first contribution was made at least five years ago, and earn-

ings on *conversions* done at least five years ago for those over age 59 ½.

Some would ask, what's the difference between spending down non-retirement account funds vs. Roth IRA funds first? It's a huge one: taxable accounts earn taxable interest, dividend and capital gain income. Roth IRAs earn tax-free income. If you're earning 5% in both accounts (remember, we're looking at the long-term here, not just today's near-zero interest rates), the \$100,000 sitting in Roth IRAs earns \$5,000 yearly, completely tax-free if you do things right. The \$10,000 that the \$200,000 taxable account earns is taxed each year. If there was a way to get that entire \$200,000 chunk into a Roth IRA today in one fell swoop (which can't be done due to yearly contributions caps), I'd do it in a heartbeat. Only then would I withdraw needed funds from my Roth IRA.

At their inception fifteen years ago, I wrote that Roth IRAs were the greatest wealth creation tool ever offered by a Congress not known for offering opportunities to build wealth. I haven't changed my mind. If I were dictator and wanted to create a cult of personality, I'd require every household to have a little statue of Congressman William V. Roth, Jr., in the middle of their dining room table.

Dear Doug: Dad Just Died. Is it too Late to do a Roth Conversion for him?

Dear Doug,

I know you have long counseled clients to do Roth conversions, especially by those in low tax brackets whose heirs are in high tax brackets. My father just died. Is it too late to do a Roth conversion from his IRA, so that my sister and I can avoid paying taxes on withdrawals at our much-higher tax rates?

Signed,

Distraught over her father's death, but also over the prospect of having to pay high taxes on an inherited IRA

Dear Distraught,

Regrettably, it's too late for whatever is left in his IRA.

This is unfortunate, because your dad could have done a series of Roth

conversions over the last several years at lower tax brackets than you and your sister are typically subject to. In addition, you would have inherited a Roth IRA, which could have been left to grow tax-free to the extent heirs are allowed (while your father wasn't subject to mandatory withdrawals on his Roth IRA, heirs are).

However, there are two things you can do to minimize the tax impact. First, in high tax bracket years, take only the required minimum withdrawals from the inherited IRA. Second, in low tax bracket years, consider taking enough additional income from withdrawals to “use up” your lower brackets. Bear in mind, you pay tax but

never penalties on withdrawals from inherited IRAs (regardless of your age). This requires careful late-year tax planning, since heirs do not have the 60-day rollover period that original IRA owners have. Once a withdrawal is made from an inherited IRA, it’s subject to tax and can’t be rolled back—no ifs, ands or butts.

For more on inherited IRAs and

the value of tax-deferred growth, take a look at *Wealth Creation Strategies* issue # 24 (Spring 2006 at <http://www.doughthorburn.com/cmsAdmin/uploads/24-ThorburnJanApr06.pdf>). After reading it, consider how much more value the *tax-free* growth an *inherited* Roth IRA has.

Dear Doug: The Bank Fouled Up My IRA Contribution / Roth Conversion

Dear Doug,
I made my IRA contribution / did the Roth conversion at the last second and the bank screwed up. Is there anything I can do?
Signed,
Late to the party

Dear Late,
There were a number of contributions and conversions for which bankers, brokers and clients made serious and irreversible errors at the last second this April and December. Here are just a few of the variations:

- One client sent the funds to an IRA that he’d forgotten was closed. He discovered this when the envelope containing the check was returned by the broker on April 18.
- Another brought a check to the bank and, in early May when the monthly statement arrived, learned that the funds

were deposited into a traditional IRA instead of the Roth IRA for which they were clearly intended. Her income was too high to be allowed a deduction for a traditional IRA.

- Still another thought she’d done a Roth conversion on December 30. The bank didn’t complete the transaction until January 5. Oops—wrong year.

Sometimes these problems can be corrected, but only when circumstances allow. The first client could do nothing. Even if the second could prove it was the bank’s fault, strict IRS regulations don’t allow a correction. She could keep the funds in what is now by default a non-deductible traditional IRA and then convert it to a Roth IRA. However, depending on the amount of any pre-existing IRA funds, converting it to a Roth may or may not cost a bun-

dle in taxes. The third can do nothing about last year’s conversion (again, there’s no exception to rigid IRS rules), but she could try again this year. However, income is likely to change and could result in greater costs in terms of taxes than would have been paid on a 2011 conversion.

The crucial lesson is STOP WAITING UNTIL THE LAST SECOND TO DO THINGS! Yes, I yelled that. Doing the wrong IRA or not doing an IRA or Roth conversion at all can cost a bundle in foregone tax savings. The idea that “the bank fouled up” doesn’t help in such situations. Keep in mind, the incompetence we’ve recently observed in the banking industry has worsened, not coincidentally during a period when what was already one of the two most heavily regulated industries in the United States has become even more heavily regulated. That alone is a very good reason to get a jump on things and leave plenty of time to correct errors.

Dear Doug: How Aggressively Should We Invest Our Retirement Funds?

Dear Doug,
We’re confused as to how conservatively or aggressively our retirement

funds should be invested in an era of near-zero interest rates. What’s your take on the current market climate?

Signed,
Confused investor

Dear Confused,

This is a subject on which everyone ends up being wrong from time to time, and I'm clearly one of those. I thought we'd have already gone into another economic tailspin after the 2009 "recovery." What do I know?

On the other hand, consider my thoughts in the retrospective look at the housing bubble in the Winter 2012 edition of *Wealth Creation Strategies*. Do you recall the two reasons I said I feel we're still in a bubble? One is the artificially low down payments the FHA continues to allow for home purchases, and now I hear they are approving loans for buyers without the best credit history—isn't this what helped to create the problem in the first place? This doesn't apply to stocks, as margin requirements haven't changed for years (they've been at 50% for taxable accounts since 1974). However, the other reason mentioned in that article does apply to stocks: artificially low interest rates, which makes the cost of owning all assets other than cash artificially low.

At one point I wrote, "This can't end well." I stand by that remark—I just don't know when.

Let's put it this way: adjusted for economic conditions, the U.S. stock market is arguably more overvalued than it was in 2007. Consider that various statistical measures, while differing somewhat, give a similar message: the civilian employment-to-population ratio peaked at 64.5% in 1999 and, after dropping to 62% at the trough of the early-2000s recession made a secondary peak at 63% in 2007. It's been hovering at about 58.5% since the so-called "end" of the recession in late 2009. In other words, would-be employees have dropped out of the labor force and true unemployment is closer to 12% (with under-employment at 15-20%) than to the much-vaunted rate of 8%. Additionally, despite the fact that short term interest rates are below the rate of inflation, there is a dearth of loan demand by those who can repay debt.

John Hussman, proprietor of

www.HussmanFunds.com, puts it brilliantly in a number of his recent "Weekly Market Comment" essays, in which he discusses stock market valuations. He may have been at his best in his March 26, 2012 commentary:

"As we examine the present evidence relating to both the financial markets and the global economy, the aspect that strikes us most is the extent to which Wall Street continues to emphasize superficially positive data in preference for deeper analysis, to extrapolate short-term distortions as if they were long-term trends, and to misconstrue freshly printed wallpaper and thin supporting ice as if they were solid walls and floors....

"An economy that is this far out of balance is one that is unlikely to avoid toppling over to some extent. Capitalism and free markets work, and America remains the most creative and innovative nation on the planet, but until policy makers and regulators wake up, it will be impossible to escape the long-term consequences of distorted markets, reckless bubble-seeking Fed Chairmen, repressively low interest rates that penalize saving and lower the bar for productive investment...and bailouts that remove all consequences for misallocating capital that could otherwise create jobs and raise living standards....

"...*How low* do you have to drive the returns *on all other competing assets* until the 'someone' holding that dollar bill has no incentive to try to trade it for some other piece of paper? This, precisely this, and only this, is what the Fed is manipulating with its massive interventions. By creating

enormous amounts of paper, and hoarding higher duration securities like Treasury securities, **the Fed is trying to force investors into risky assets until the prospective returns on all competing assets are driven so low that investors and banks holding cash are willing to just sit on it.** In short, the Fed has focused its efforts on creating a bubble in risky assets, on the misguided, semi-psychotic, and empirically disprovable notion that this will make people feel wealthier and get them to spend and borrow - despite the fact that their incomes can't support it without massive government transfer payments.

"Aside from periodic jolts of enthusiasm that release some amount of pent-up demand for a few months at a time, what this policy has actually produced is *near-zero prospective returns* on nearly every class of assets. These [risky] assets will now go on to actually *achieve* tepid returns for an extended period of time, *provided* that things work out well, and a collapse in the prices of risky assets if investors ever get the inclination to demand a normal return as compensation for the risk they are taking."

(*Italics* in the original; **bold** is mine.)

Reading between the lines, Hussman—who's been wrong with me for the last two years—implies he wouldn't at all be surprised by a major market decline. So, whatever you do with your funds, I would be very conservative at current stock market prices. Nearly two years ago, I prematurely wrote "cash can be king," by which I mean cash equivalents currently earning a miniscule return. Maybe now is the time but, as I often tell my wife, I could be wrong.