



**Financial Planning Notes**

Client Newsletter

March, 2010

*"Look around the table. If you don't see a sucker, get up, because you're the sucker."*

**Amarillo Slim Preston**  
**Professional Gambler**  
(see the article on page 3)

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**Roth and Roll: Time to Convert?**

This will be a big year for Roth conversions. One-year-only tax law changes will make a move from a traditional IRA to a Roth IRA extremely advantageous for some investors.

First a primer course: Contributions to a traditional IRA (including SEPs and SIMPLEs) provide a tax deduction in the year they are credited to your IRA account (up to applicable contribution limits). Once you begin taking distributions after age 59 ½, you are responsible for paying income tax on the entire amount distributed at your earned income tax rate. After age 70, you must begin taking distributions.

Roth IRAs, on the other hand, do not offer an immediate tax deduction, but all distributions after age 59 1/2 are tax-free. Also, there are no required distributions after age 70.

Roth IRA conversion has not been an available option if you have income over \$100,000. Starting this year, the \$100,000 income limit is permanently repealed.

The conversion process is simple: Assets from your traditional IRA are rolled to a ROTH account. You are then responsible for paying income tax on the entire amount of the distribution, but you pay no penalty for withdrawing the funds before age 59 ½ (provided you complete the rollover as required).

So the big obstacle for a Roth conversion is paying taxes on the amount of the traditional IRA distribution. If you have \$80,000 in an IRA, elect to make a conversion and are in the 28% income tax bracket, you will have a tax bill of \$22,400. That amount could be even more if a large IRA distribution pushes you into a higher tax bracket.

So why not just pay the tax bill out of the distribution? Well, because it's a bad idea. IRS rules say you need to roll over all distributed assets into the Roth. Any amount you don't deposit into the Roth will be subject to a 10% penalty (plus income tax). So if in the above example, you only deposit \$57,600 and hold the rest to pay your taxes, you will have a penalty of \$2,240 (and if you hold more assets out of the rollover to pay that penalty, there'll be a bigger penalty!)

Okay, so clearly you should only convert existing IRA assets to a Roth if you can pay the tax bill from other assets. Now on to an explanation of the one-year rule changes. If you complete a Roth conversion during the calendar year of 2010, you can elect to pay half of the tax bill on your 2011 return, and the other half on your 2012 return. This gives you a lot of extra time to come up with the money to pay the taxes on the conversion. But here are some important questions to ask yourself before you decide to do a conversion:

**Will I need to start taking distributions within ten years?** The power of a Roth account is that assets

grow tax-free. If you begin taking distributions right after conversion, the only thing you've done is front-load your entire tax bill. You want to let the rolled over assets grow as long as possible. So if you think you will need to take distributions within ten years, the value of a conversion is diminished.

**Will I need to take distributions at all?** Some retirees can fully fund their retirements from other assets and intend to leave their IRAs to beneficiaries. In that case, the Roth IRA has the huge advantage of not requiring distributions during the owner's lifetime, therefore preserving more of the assets for beneficiaries.

**Will I be paying more or less in taxes in the future?** Simply put, if you expect your tax rate to be higher in the future, it is better to convert now. Future rate increases could be driven by rising personal income, by new higher Federal tax rates or a combination of the two.

**Will I be able to pay half the tax bill out of non-IRA assets by April of 2012 and the other half by April of 2013?** As previously mentioned, a conversion loses its advantage if the taxes on the IRA distributions are paid from IRA assets.

If you decide to go ahead and make the conversion on 2010, there is another advantage. If you have "buyer's remorse," for example if the value of the account goes down and the tax bill is now a much larger percentage of the assets, you have until October 15, 2011 to change your mind. That's right; you can recharacterize the rollover, and in essence undo the conversion.

And if that wasn't crystal clear, you know what to do: Give us a call!

Steve Tepper

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## The Cost of Behavioral Investing

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We talk often in our newsletter about behavioral factors on investor returns. This month we found yet another study that supports the theories of behavioral investing.

A study from last year released by market research firm Dalbar concludes that from 1981 to 2005, the average mutual fund returned 12.3% annually while the average mutual fund investor only earned 7.3%. But it's not just mutual funds. Investors who bought individual equities did even worse, earning 1.87% while the S&P 500 returned 8.35% from 1989 to 2008. And bond investors got 0.77% compared to 7.43% for the index.

Dalbar found that the average mutual fund investor looks for "hot performing" mutual funds (and thanks to the financial media and Morningstar, it is easy to identify hot performers) and ends up pouring money into funds at the end of bull markets. On the other end of the spectrum, the tail end of the bear market is when the average investor is most likely to feel the greatest sense of panic and pull their money out.

And that is one perfect recipe for lousy returns: Buy high, sell low.

But it isn't just poor market timing that hurts the "hot fund" chaser. There is the phenomenon we have written about once or twice (or a two dozen times) in past newsletters: there is no evidence that last year's hot performer is more likely to outperform in the future.

Financial Advisor Magazine published some statistics on that subject in February. They reported that of the five top performing mutual funds of the 1980's, only two beat the market in the '90's. And only two of the five best funds of the '90's outperformed the market in the '00's. They managed to find just one fund, Davis New York Venture, that beat the market in all three decades.

The Davis fund could very well beat the market this decade as well. Care to bet your nest egg on it?

Me neither.

Steve Tepper

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## Slim Chance – What Can We Learn From The World’s Greatest Gambler?

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The end of the last article is a perfect segue into this one. Betting everything on a single investment is not a good plan. In fact, any financial planning that relies on betting is a really bad plan.

Many people I know who don’t invest in capital markets tell me the stock market is the same as gambling. I beg to differ. While both gambling and investing carry the possibility of large gains and large losses, there is a fundamental difference: Gambling is less than a zero sum game while investing is greater than a zero sum game. It is not true for every gambler or investor and not for all periods of time, but the sum gains for all gamblers is negative, while the sum gain for all investors is positive (even when you include the really good gamblers and the really bad investors).

The difference in attitude between gamblers and investors can be illustrated by a quick visit to [amarilloslim.org](http://amarilloslim.org), the official website of the self-proclaimed “world’s greatest gambler,” Amarillo Slim Preston. Preston won the World Series of Poker’s Main Event back in 1972 and is a member of the Poker Hall of Fame.

Some of Preston’s more interesting wagers are listed on the website. They include:

- Playing pool against Minnesota Fats using a broomstick
- Betting on which sugar cube a fly would land on in an Arkansas jail. (The website provides no information on why he was in jail.)
- Beating Evel Knievel in golf with a carpenter’s hammer
- Betting that two out of thirty cab drivers in Dallas would have the same birthday
- Beating Bobby Riggs playing Ping-Pong with a skillet
- Betting that a champion bowler couldn’t bowl seventy blindfolded

These are all amusing anecdotes, and some of them may have actually happened! If you were present, might you be tempted to throw a fiver or two in for the entertainment value alone? (Except the jailhouse wager – I’d recommend saving your money for a good lawyer.)

And that is the lesson we can learn from Amarillo Slim. Gambling is fun for amusement and for stakes you won’t care about losing. I for one don’t have the risk tolerance to go all in on a bet that I could make a free throw with a football.

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## A Hedge Fund Report Card

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One day last month while you thought I was hard at work picking a great stock to invest you in (okay, you knew I wasn’t doing that), I came across an interesting article on [investopedia.com](http://investopedia.com) about hedge fund failures. The list of stories of million and billion dollar losses was staggering, both because of the similarities that led to the funds’ collapse (usually a over-concentration in a risky position) but also the diversity of different funds types. It sure left me with the sense that hedge fund investing is about as safe as taking tango lessons in a mine field.

Here are some of the most disastrous losses of the last few years, and how they occurred:

**Bailey Coates Cromwell Fund** was an event-driven London-based fund. Eurohedge named them the Best New Equity Fund of 2004. They made a series of bad bets on U.S stocks in 2005 and the fund lost 20% (about \$260 million) in just a few months. Investors fled, and the Best New Equity Fund of 2004 was dissolved in June, 2005.

**Marin Captial** was heavily invested in credit arbitrage. Arbitrage investing is supposed to be virtually risk-free. The classic example is finding two apple markets, one where apples sell for two cents, the other where they sell for three cents. An arbitrage trader will buy the two cent apples, then sell them at the three cent market.

Credit arbitrage investors buy the debt of a company

(bonds) and short the company's stock. They make a profit on the difference in prices of the securities. One thing that can turn the scenario from low-risk to disaster is a sudden large drop in the stock price accompanied by a credit downgrade.

So a credit arbitrager would do well to find stable companies with solid credit ratings and little stock price movement. Marin Capital selected General Motors. Oops! GM was downgraded to junk in 2005, and that was the end of Marin.

**Tiger Funds** was a high-flyer in the 1990's. In 1998, manager Julian Robertson believed that the tech rally was over. Based on basic fundamental analysis, he saw outrageous price-to-earnings ratios and companies that had no short-term promise of profitability. He shorted the bejeezus out of the sector.

The irony here is Robertson was right, but he was a little off in his timing. The tech sector was overpriced and the bubble was ready to pop. And it did pop. But not for another two years, during which the run-up in the sector cost Tiger's investors \$17 billion of the \$23 billion they invested.

**Long Term Capital Management** was another arbitrage fund that attracted investors with the promise of low risk investing that took advantage of temporary changes in market behavior. In 1998, Russian markets were in turmoil and the fund invested heavily, believing it was a short-term situation. They bought Russian bonds and leveraged their positions using derivatives. Russia defaulted on its debt in 1998. The fund was losing hundreds of millions of dollars per day but hung on, believing their positions were correct.

Losses piled up to \$4 billion, and eventually the fund was liquidated.

**Amaranth's** manager Brian Hunter was one of *Traders Monthly's* top traders in 2006, after he made the right bet on natural gas futures and reaped the rewards of a tripling in price thanks to Hurricanes Katrina and Rita. He made the same bets in 2006 but a mild hurricane season resulted in \$6.5 billion in losses.

Ugly stories, and good reminders that high expected returns can only be achieved through greater risk exposure, and that this year's darling is often next year's goat.

Steve Tepper

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## Thanks for Your Recommendations!

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We are continually honored with the highest praise we can imagine... your recommendation to your family, friends and neighbors.

Like any business, we thrive on word of mouth recommendations from our friends and clients. We love helping new friends that are sent our way and we strive to do everything possible to provide them the same great client experience you receive. Thanks!



**"The sports car and sailboat are investments for my retirement. I'm using them to attract a younger woman who can support me in my old age."**

Northstar Financial Planners is:

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