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BFAS Money Line

Jobless Recovery

Business activity as measured by the **gross domestic product continues to show growth**. As the stimulus winds down, many are concerned that the growth will wind down with it, especially in the second half of 2010.

Business profits are still good due to slashing of expenses, not big increases in sales. Without sales increases, businesses are unlikely to re-hire personnel, their biggest expense.

Businesses are also concerned about regulatory uncertainty and tax uncertainty as well as potential climate and health bill impacts. This uncertainty is not conducive to making the job or equipment investment decisions necessary for growth. **Congressional attempts to spur grow with tax dollars through incentives will largely fail until the issues above are settled**.

The economy must generate almost 150,000 jobs monthly just to absorb new entrants to the jobs pool. Thus, weak growth almost assures near 10% unemployment at the end of the year. Those holding out for a quick recovery and a return to their old jobs (we all know someone in this situation) need to take any job available and reduce their lifestyle going forward.

Foreign stocks and bonds have continued to perform well although Greece's problems are weighing down foreign returns.

China is not happy with us for several reasons (Google, trade, Taiwan, Dali Lama**). Internally, China is being pushed to sell some of their horde of US Treasuries. This would cause our interest rates to rise and increase the burden of our debt**. However, China would be shooting itself in the foot. Slower growth here means less buying of Chinese products and fewer jobs. **Since full employment is job one for the Chinese government, there are not likely to follow through**. They will, however, continue to bluster.

Many people call the last 10 years the lost decade of investing. The S & P 500 lost 9% over the ten years ending December 31st. This is the biggest decade loss in history, far surpassing the .3% loss in the 1930's. Yet**, a balanced portfolio of stocks and bonds earned 33% over the same time frame**.

When interest rates start rising, possibly as early as the end of the year, holders of bonds may see values decline. The longer the term of a bond, the bigger it will drop in value. Typically, a 30 year bond will drop 8% for every 1% increase in interest rates. Shorter term bonds will drop significantly less.

However**, this doesn't matter if you buy and hold bonds to maturity.** In that case you get all your interest payments and a return of your principal.

It can affect bond funds, though. A bond fund manager might shorten the average maturity to reduce the impact. Also, they will be buying new bonds with the higher interest rates**. In looking back at historical performances of the bond funds I use, their returns were reduced but still positive in rising interest rate environments.**

With all the uncertainty about the economy and the stock market, I don't recommend reducing bond exposure just because interest rates might start rising. Bond funds are an invaluable safety valve when stocks drop.

Small cap stocks have beaten large cap stocks as is typical coming out of a recession. Large cap stocks are likely to perform better going forward. All categories are up double digits. What a difference a year makes! However, the slow growth we are seeing means you should keep your portfolios conservative at this time.

Asset Class	1 Yr Rtn (01/31/10)
S & P 500	+ 33.14%
NASDAQ	+ 45.44%
Lg Cap Gwth	+ 35.76%
Lg Cap Val	+ 32.89%
Mid Cap Gwth	+ 39.73%
Mid Cap Val	+ 43.98%
Sml Cap Gwth	+ 39.62%
Sml Cap Val	+ 44.52%
Foreign	+ 39.68%
Interm Corp Bds	+ 16.95%
Foreign Bds	+ 20.05%
Commodities (DJ – AIG)	+ 16.52%

Odds and Ends

Estate Tax – **Last year ended without Congress extending or fixing the estate tax. Hence, for 2010, there is NO federal estate tax (Virginia ended the state estate tax recently also).**

Congress has discussed setting the federal estate tax exemption at $3.5 million per person and reducing the tax rate from 55% to 45%. However, with health care soaking up all the time, they never completed work on the extension/fix.

Thus, under current law, there is no tax this year and then in 2011 the exemption amount is only $1 million.

Another big estate tax change for this year is the step-up in basis. In the past, inherited assets received a step-up in tax basis to the value on the date of death. In 2010, only the first $3 million will receive a step-up in basis if inherited by a spouse ($1.3 million for non spouses).

You can imagine the problems where a family farm worth $3 million is inherited in 2011 by the children. The estate taxes be higher than they would have been in 2009 due to the $1 million dollar exemption (versus 2009's $3.5 million). In addition, if they sell it, they will pay capital gains taxes on the difference in value of the sales price and whatever dad (or granddad) originally paid for the farm (assuming they can figure that out!).

Loss of the step-up in basis creates an accounting nightmare for heirs. Also, the executor is responsible for allocating the available step-up exemption and providing tax basis information to the heirs and IRS (with fines for failing to do so). You can see how a family member as the executor would have a huge conflict of interest in the allocation of the step-up among siblings.

Congress might fix this mess later this year. But, there is some question as to whether they can make a new law (permanent $3.5 million exemption plus step-up in basis) retroactive to January 1st. They routinely do so for income taxes, but estate taxes are a different animal. It all makes for interesting times in estate planning and guaranteed full employment for attorneys!

Taxes – There are some recent tax law changes that could reduce your 2009 taxes.

American Opportunity Credit – You get a 100% deduction for the first $2,000

of tuition and 25% on the next $2,000 (total deduction $2,500).

Energy Credit – Homeowners get 30% credit on expenses up to $5,000 used for heating and air conditioning, biomass stoves, some types of energy efficient windows, doors and installation. There is another credit of 30%, with no cap, on solar systems, wind turbines and geothermal heat pumps.

New Vehicle Deduction – State and local sales taxes on a new car, light truck, motor home or motorcycle with a value up to $49,500 (purchased between February 16, 2009 and December 31st, 2009) may be deducted.

Virginia College 529 deduction – starting in 2009 you can deduct up to $4,000 on your Virginia taxes (previously $2,000) for a contribution to each child's 529 plan. Note: with two parents contributing, you can deduct $8,000 per child per year. Those over 70 can deduct the full amount of their contribution.

Tax Harvesting – if you aggressively harvest capital losses in the last two years, you can use those losses to offset any capital gains distributed in 2009. If your losses are still higher than your gains, you can deduct up to $3,000 against your ordinary income. Any losses still left over can be carried over to future years.

College Planning – this time of year, a lot of you are thinking about paying for college. Some have children leaving soon, some have toddlers. Here are some thoughts.

College saving or retirement savings; which is more important? You, or your children, can borrow for college, you can't borrow for retirement. So, make sure you are on track for a secure retirement before making college savings contributions.

"I'M SURE IT'S SOME SORT OF PUBLICITY STUNT TO GET THE ECONOMY MOVING AGAIN."

If you want to save for college, look first at plans in your own state, especially if they offer tax advantages (state tax deductions).

Prepaid tuition or college savings plans? Prepaid tuition plans put the risk of higher tuitions on the state and protect against losses. However, in Virginia (and most other states), **if your child does not attend an in-state public university, you will only receive your contributions minus administrative expenses plus a money market rate of return.**

The advantage of **college savings 529 plans** is that the money is yours to use wherever your child goes. It's also available for most college expenses, not just tuition. However, **the downside is that your money is invested in funds that have downside risk**. For example, in Virginia's College America plan, the American Funds Balanced Fund lost 25% in 2008, yet still had a 10 year return of 5.93% per year.

Thus, if you had a child who decided to go to Virginia Tech and you had a Prepaid Tuition plan, tuition would be covered even though tuition increases have averaged about 7% annually. On the other hand, if your child decided to go to the University of North Carolina, you would basically get your money back and be way behind on tuition because tuition had been going up 7% annually.

If you had put the money into American Balanced, your money would have grown 5.93% annually, but you would have been stressed to see it drop 25% in 2008. However, you could use the money at any university and you don't need all the money in one year (they are going to be in college for four years, at least). So, 2009's 21% increase in the fund would have eased some of the pain with several more years of potential gains to go while your child is in college.

Roth IRA conversions -

This year, it is easier than ever to convert your traditional IRA to a Roth IRA. Previously, your Adjusted Gross Income had to be under $100,000 to do so. Now there is no income limit on conversions, although there are still income limits on contributions to Roth IRAs.

Now that you can convert, should you? The correct answer depends upon your specific situation. There are a myriad of Roth Conversion calculators on the Internet. Virtually none of them take all the important factors into account and rarely will any two calculators give the same answer.

If you are in a higher tax bracket today than you will be in retirement, a Roth IRA conversion is probably NOT a good idea. Better to contribute to 401(k)s and traditional IRAs to get the tax deductions in today's high tax bracket.

If you are going to be in the same tax bracket in retirement a Roth Conversion can make sense IF you have sufficient cash available to pay the taxes without drawing from retirement accounts.

If you are going to be a higher tax bracket in retirement than you are today, Roth Conversion is almost certainly a good idea.

Now, if you are contemplating a conversion, **how much should you convert, all or a portion of your Traditional IRA? I'm a fan of just converting enough to fill up your current tax bracket.**

Suppose your taxable income (gross income minus deductions and tax credits) is $50,000 and you are married filing jointly. You are in the 25% tax bracket. In this case you could convert up to $18,000 and still remain in the 25% tax bracket.

There is a potential tax gotcha with Roth IRA conversions. Some people have IRAs where they deducted contributions (pre-tax) and other IRAs where contributions are after-tax. They might believe they can just convert the after-tax IRA with almost no tax due while leaving the pre-tax IRA intact. Unfortunately, the IRS says no. The conversion amount will be divided by the total of all IRAs and only that percentage will be tax free. Beware! Many advisors are not clear on this issue!

This discussion just touches the surface of the Roth Conversion question. Other issues include desire to leave an inheritance (Roth IRA better), income needed in retirement, sources of income, etc. Bottom line is this decision is not simple and should be made with the help of your advisors not some oversimplified calculator!

Funding the SNT

Most people understand that a Special Needs Trust is a critical component in providing a higher quality of life for children with disabilities. Two additional questions must be answered: **set up the trusts while alive or only after death, and what assets should go to the trust?**

I prefer setting up the trust while you are still alive. This gives you the opportunity to see how it works (or doesn't), how the trustee uses the money for your child's benefit, how the money is managed, etc. You may be able to make corrections to better serve your child.

For example, you might have chosen a family member to manage the SNT. After observing how this worked, you might decide that using some sort of Community Trust would be better (more professional management, fewer conflicts of interest).

The other issue is what assets to dedicate to the trust. While you are alive, you should only contribute enough so that you still have sufficient retirement assets. After death, it becomes an issue of equity between children. How much do you put into the SNT versus how much do you want to leave to your other children?

You can leave pretty much any asset to the SNT, but **many people prefer to purchase a permanent (not term) life insurance policy. You would want to purchase this policy early enough that the cost would be lower.**

Some people can't afford the permanent life insurance in addition to saving for retirement. In that case, they might leave as much as they wish of their residual estate to the SNT.

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