

MARKET NEWS

Keeping our Clients Informed

Fourth Quarter 2005



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Another Year of the Haves and Have-Nots

There was little to cheer about this year unless you happened to be invested in either mid and small-cap stocks or the energy sector. Despite analysts' predictions that the stellar performance in recent years of the mid and small-cap sectors would come to an end in 2006, those two groups were the only major domestic indices to generate meaningful returns. Fortunately for our clients, all of our equity allocations called for significant exposure to these segments of the market via indexed mutual funds or exchange traded funds.

The S&P Midcap 400 had the best returns at 10.7%. The S&P Smallcap 600 came in next at 6.6%. From there, the S&P 500 gained only 3% and the Dow Jones Industrials finished last down 0.6%.

As one would expect, energy related stocks were the best performers. The energy sector within the S&P 500 gained over 29%. This accounted for approximately one tenth of the entire S&P 500 return. Excluding this group, the S&P 500's return for the year would have been well below 2%.

Bonds didn't fair much better. The Federal Reserve continued its relentless campaign of interest hikes. Each of the eight times the Fed met during the year, they raised short-term rates by a quarter point. Fed funds, which started the year at 2¼ percent, now stand at 4¼ percent. With inflation well under control, long-term interest rates have remained flat during the year. Combine this with the Fed increases and you're left with a very flat yield curve. Currently, there is little difference between the yield on the 2, 5 and 10 year treasury bonds. Although this has left long-term bond prices flat, the yields remain historically low.

Going forward, we don't see much changing for the bond market. The Fed is likely to raise rates two more times, putting more pressure on short-term bonds. Furthermore, with inflation under control and continued trade deficits which get translated into strong buying pressure on longer-term treasuries, it is doubtful that we'll see long-term interest rates go up much from here in 2006.

Stocks, on the other hand, should fair better in 2006 as the Fed ends its rate hikes. We are also hopeful that earnings will get a boost as energy prices stabilize. Additionally, we think that it is time for large-cap stocks to outperform.

Taxable vs. Non-Taxable Savings

A new retirement savings option will be added to the wide array of current plans already available in 2006. It's called a Roth 401(k), and, as the name suggests, it combines the features of the traditional 401(k) with those of a Roth IRA. With so many different retirement savings options available, we thought it would be useful to revisit the topic this quarter.

The laundry list of plan names can seem very confusing, but whether you're talking about an IRA, 401(k), SEP or other plan, the general concept remains the same; open a special type of account, contribute cash to it and the earnings grow tax-free for the life of the account.

The differences between these plans can usually be boiled down to two things; how much money you can contribute in any one year and how the distributions are taxed when it comes time to use the funds. The decision as to which plan is right for you will almost always be based on these two questions.

The amount of money that can be

contributed in any one year will be determined by statutory limits and/or income limits. The more common plans such as IRA's (traditional or Roth) have modest limits that cap the annual contributions to just a few thousand dollars. These limits have started moving up in recent years, but they still are nowhere near the levels most affluent individuals need to save. Furthermore, your ability to save into these plans begins to phase out at \$95,000 in income for single filers, and \$150,000 for joint filers. Plans that do have high annual contribution limits tend to be very specialized and tailored to businesses with few employees and the self-employed.

The catch to these plans comes when it is time to pull the money out. Almost always, every dollar that is withdrawn is taxed as ordinary income. The exception to this has been the Roth IRA. Under this plan, distributions from these accounts in no way count towards your taxable income. Because this has been such a good deal, Roth IRA's have had one of the lowest contribution limits of any plan (\$4,000 in 2006 or \$5,000 if you're over 50).

It's for this reason that the new Roth 401(k) is a boon to many investors, especially high-income individuals who could not contribute to a Roth IRA in the past. Because there are no income stipulations and the contribution limits match the regular 401(k) rules, in 2006 employees can put away as much as \$15,000. This limit applies to both types of 401(k)s, so you can only contribute a total of \$15,000 between the two.

So far, 35% of the 198 respondents to the latest survey by Hewitt and Associates, an employee benefits consulting firm, have indicated that they're likely to offer the Roth 401(k). We expect this new plan will be well received and will become a common option for most employees.

So what's the hitch? The only downside to the Roth accounts (IRA's or 401(k)'s) is that all of the contributions are made with after-tax dollars. That is to say that you cannot deduct or reduce your taxable income by the amount of your contribution.

This also means that this type of account is not right for everyone. Because the tradeoff is either the current tax deduction or tax free distributions in the future, one has to weigh which

benefit means the most. The rule of thumb is that the longer the funds are to stay in the account, the more sense a Roth account makes. This is because there will be more time to accumulate those tax-free gains and income. Conversely, if your time horizon for needing those savings is short, the tax deduction you would get this year would be worth more.

The Roth account overcomes one of our greatest complaints about tax-*deferred* savings (i.e. the traditional IRA or 401(k) plan) – the conversion of long-term capital gains into ordinary income. Never forget that there is a significant difference between the tax rate of long-term capital gains and ordinary income. In the case of high earners, ordinary income is taxed at twice the rate of long-term capital gains.

In an ideal situation, you would want all of your retirement income to come from selling long-term appreciated assets. This, of course, is impractical from a planning standpoint because of the price fluctuations those assets experience in any given month. That is why a meaningful portion of your retirement income will need to come from interest and dividends (ordinary income).

Generating interest and dividends in a traditional tax-deferred account, such as an IRA, is fine because they'll be taxed just the same when they're withdrawn. However, imagine realizing the gain on a long-term stock in that account. When the money is used to pay your bills, it will be taxed as ordinary income regardless of the fact that it came from selling a few shares of stock that you've owned for several years. You may have doubled your tax bill simply by having the shares in the wrong type of account.

We've always said that the most expensive way to fund your retirement is through tax-deferred savings because the taxes upon withdrawal would be so high. A Roth account completely does away with this problem because those distributions are not included on your tax return. Until now, it has been hard to accumulate enough money in Roth savings to make much of a difference in your retirement portfolio. With the annual contribution limit increasing over three fold with the new Roth 401(k) that has changed significantly.