ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

In This Issue

June 11, 2009

New Rules for Roth IRAs

Two weeks ago, we covered the multiple advantages the Roth IRA has over its traditional IRA big brother. Now it's time to take a look at how, starting in 2010, even more of you will be able to reap the benefits of investing in a Roth IRA.

As we mentioned last time, the Roth IRA, since its debut in 1997, has been denied to many two-income families or those with high incomes, through a cap on income eligibility—exceed the cap and you can't contribute to a Roth. For tax year 2009, single tax filers who make between $105,000 and $120,000 per year are limited or prohibited from contributing; married couples, filing taxes jointly, who make between $166,000 and $176,000 are similarly limited or barred altogether—there is also a salary cap on conversions from other IRA types into Roth IRAs—if you make more than $100,000 either as a single filer or a married couple, you cannot convert. But we're about to get a window into the Roth universe through a change to that IRA conversion rule next year, and it's a great time to start preparing for this event.

Passed back in 2006, the Tax Increase Prevention and Reconciliation Act (primarily intended to extend the lower capital gains and dividends tax rate) included a provision that removed the salary limit for conversions from IRAs to Roth IRAs in 2010. While high income investors will still be barred from opening or contributing to Roth IRAs in subsequent years, there will be nothing stopping them from converting other IRAs into Roth IRAs (so long as Congress allows the loophole to remain open), year after year, if they so desire.

When making the conversion from a traditional IRA to a Roth IRA, the first thing you need to think about is taxes. When you convert to a Roth IRA, you will be subject to taxes on gains—for a traditional IRA, this will be the entire sum of the deductible contributions you made over the lifetime of the account plus any gains, while for an IRA to which you've made nondeductible contributions, you will only have to pay taxes on any gains earned over and above your after-tax contributions. (Many investors find themselves making nondeductible IRA contributions due to the salary limits on traditional IRAs for those participating in employer-sponsored retirement plans. In tax-year 2009, if you contribute to say, a 401(k) plan and make more than $55,000 as a single tax filer or a combined $89,000 for married couples filing jointly, your tax deduction for contributions to an IRA begins to be limited—if you make more than $65,000 ($109,000 for married couples), your contribution becomes nondeductible.) If you have a traditional IRA to which you've made both deductible and nondeductible contributions, you'll be taxed on any gains plus the deductible contributions.

Conversions made in 2010 alone have a special provision—you don't have to pay your tax bill all at once. You can spread any resultant income taxes from the conversion out equally over the next two tax years. In years after 2010, so long as Congress doesn't close the loophole, you'll still be able to morph your IRAs into Roth IRAs, but you'll have to pay the resulting tax liability in a single year. While it will be a bit of a hassle in terms of paperwork and tax calculations, you can make as many conversions as you want from IRAs into Roth IRAs going forward; you just won't be able to contribute to your existing Roth IRAs so long as you are over the income limits.

Let's go through a few scenarios one might encounter, from simple to complex—these apply both to current conversion rules and those that will be in effect next year. If you opened a nondeductible IRA several years ago, made $12,000 in after-tax contributions and have earned an additional $3,000 in gains, you'll only have to pay taxes on the $3,000 gain when making the conversion. If you have a traditional IRA, made that same $12,000 in tax-deductible contributions and also have $3,000 in gains, you would be taxed on the entire $15,000 in the account when converting to a Roth IRA, since all of the money contributed was made pretax.

Those examples are both pretty straightforward, but where it gets complicated is when you have multiple IRA account types and want to start making conversions—this is likely the type of situation many people transforming traditional IRAs into Roth IRAs will find themselves in.

Let's say you have a traditional IRA account worth $60,000, $40,000 of which comes from tax deductible contributions and $20,000 of which is investment gains. You also have a $40,000 nondeductible IRA, $30,000 of which came from after-tax contributions and $10,000 of which is investment earnings. You decide you'd like to take advantage of the new conversion rules and move your nondeductible IRA into a Roth IRA account. While it would be easy to assume that only the $10,000 in earnings is taxable, with the IRS, there's always a catch—and in this case the catch comes from owning multiple IRA accounts. You are required to total up the value of all of the taxable funds in all of your IRA accounts and that percentage of assets determines how much of the amount you are converting to a Roth IRA will be taxable. So here, you have to add the entire $60,000 in the traditional IRA to the $10,000 in earnings in the nondeductible IRA and then divide by your total IRA investments of $100,000, to find out that 70% of any amount you convert to a Roth IRA is subject to income tax. In this case, of the $40,000 IRA you wish to convert over, $28,000 will be taxable. (This means of calculating taxes only applies on partial conversions—if you were converting all of your IRA accounts at once, each would be taxed based on its own liability.) This may mean that if you are in a similar situation and want to make a conversion, you might want to think about converting all of your IRA accounts, since you'll effectively be paying a higher tax bill by only moving some of your assets—you'll owe taxes on what were after-tax investments at the time of conversion, plus taxes down the line on whatever remains in the traditional IRA account.

You should also note that it is not a great idea to count on the funds you convert into Roth IRAs being immediately available as tax-free distributions. Remember that there is that five-year seasoning rule (which still applies even if you are over age 59½) and a 10% penalty for early withdrawals even if you just paid out income taxes on the conversion. You'll need to have cash available to pay the tax or it may make little sense to do the conversion in the first place. If you're thinking of using some of your traditional IRA assets to help cover the taxes on the conversion, be aware that you'll suffer the 10% early withdrawal fee if you are younger than 59½, and you'll also owe income taxes on the amount you withdraw to pay the income taxes due on the conversion.

Who Should Convert?

While the decision to convert traditional IRAs into Roth IRAs should obviously be determined on a personal basis, there is one situation we can think of where it might be beneficial. If you'll be in a higher tax bracket when you anticipate taking withdrawals, it might be better to pay taxes now on your IRA assets in the conversion process and then not have to worry about any future taxes down the line. It could also be advantageous to make the conversion if you have a traditional IRA that you feel you won't ever need to tap into (should you be so lucky) and you don't want to have to deal with RMDs, instead preferring to allow your account to grow tax free indefinitely, perhaps to be left for your heirs. It probably does not make sense to convert if you think you'll be in a lower tax bracket when it's time to take withdrawals or if you'll need to take distributions within five years of making the conversion.

If you think this kind of conversion could be of benefit to you, we suggest you speak to a tax or retirement planning professional and carefully consider the tax implications before doing so.

Fidelity Manager Moves

Fidelity has made a number of manager changes recently, some of which took effect on June 1st and several which will go into effect on July 1st.

The first group of changes, now complete, were made to finish Derek Young's transition into his role of Chief Investment Officer of Fidelity's Global Asset Allocation Group, which he took on in February.

Geoffrey D. Stein has taken over the Asset Manager funds, as well as VIP Asset Manager and VIP Asset Manager Growth, succeeding Young. He also has been named co-manager of Global Balanced with Ruben Calderon and co-manager of Broad Market Opportunities with Christopher L. Sharpe, also succeeding Young on both funds.

Christopher Sharpe has joined Joanna Bewick as co-manager of the Fidelity, Advisor and VIP Strategic Income funds, Strategic Real Return and Strategic Dividend & Income, succeeding Young. He will also join Andrew J. Dierdorf as co-manager of Fidelity Four-In-One Index, succeeding William Hall. Sharpe will continue to manage the Freedom funds, the Advisor Freedom funds, the VIP Freedom funds, the VIP Investor Freedom funds, the Freedom K funds and Fidelity's 529 college savings plan for New Hampshire, Massachusetts, Delaware, Arizona and California.

Andrew Dierdorf has joined Jonathan A. Shelon as co-manager of the Income Replacement funds, succeeding Sharpe. He will continue to co-manage Four-in-One Index, Fidelity's 529 College Savings Plans and Dynamic Strategies.

The second batch of changes, which, as mentioned, will take effect on July 1st, were triggered by Jennifer Uhrig, a 22-year Fidelity veteran, retiring from her management position at Blue Chip Growth.

Sonu Kalra will succeed Uhrig at Blue Chip Growth. Kalra has been managing the OTC fund since 2005 and joined Fidelity in 1998 as an analyst. His resume since then includes stints at several of Fidelity's technology-focused Select funds and he served as leader of the technology group for several years as well.

Gavin Baker will succeed Kalra at OTC and he will continue to manage Select Wireless. He joined Fidelity's equity research department in 1999 and has since managed several Select funds.

Kristina M. Salen has been named manager of Select Telecommunications, Advisor Telecommunications and VIP Telecommunications, succeeding Baker. She will continue to manage Select Multimedia, which she took over in 2006 (the same year she joined the firm).

Kyle L. Weaver has been named co- manager of Select Wireless, where he will share duties with Baker. Weaver will continue to manage Select IT Services. He joined the firm in 2008 as an equity analyst.

None of the changes listed above should be of concern to investors in the funds effected.

Smaller Investors Shut Out of Vanguard Treasury Money Markets?

Vanguard announced on June 2nd that it is planning to merge its Treasury Money Market fund into its Admiral Treasury Money Market fund in August (around the 11th according to SEC filings), a move that will lower expenses for investors in Treasury Money Market.

Currently, both funds are closed to new investors. Vanguard is also closing its Federal Money Market fund, citing the need to protect investors from historically low yields (which was also the reasoning for closing the two Treasury funds back in January—current shareholders in all three funds who invest directly with Vanguard are permitted to add up to $10,000 per day per fund account). As of June 9th, Federal Money Market was yielding 0.32%.

The yield on the Treasury Money Market Fund is near zero—it has hovered around 0.05% for the last week or so. The Admiral Treasury Money Market Fund's yield is now 0.18%. The funds' operating expense ratios differ by 13 basis points, or 0.13%, almost exactly the 0.13% difference in their yields.

What Vanguard didn't mention in its press release, but revealed in its SEC filings, is that small investors may never have a shot at a Vanguard Treasury Money Market fund again. While Treasury Money Market's minimum was $3,000 when it was open, and the Admiral fund's minimum was $50,000, after the merger the remaining fund will maintain its $50,000 minimum. So, if the fund reopens to new shareholders in the future, it will still have a $50,000 minimum.

Presumably Vanguard could someday open a new, lower-minimum Treasury money fund, but for now, small investors will not have that choice in their Vanguard menu.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and $900 million dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.