

Is an IRA Conversion Right for You?

Morningstar's marketing team was recently putting together a compendium of our company's best investment ideas for 2010, seeking input from me and several of Morningstar's other newsletter editors and directors. I hemmed and hawed for a few minutes before giving them an answer. I do have a short list of favorite investments, but given the market's rapid ascent over the past eight months, there simply aren't all that many I would characterize as screaming buys right now. But then I realized that my best investment idea for 2010 wasn't a single security, but rather a strategy: IRA conversion.

Whereas investors earning more than \$100,000 cannot currently convert their traditional IRA assets to Roth status, that income limit will be lifted in 2010. That means that all investors, regardless of income level, will be able to convert their traditional IRA assets to Roth next year. And while retirement savers will have to pay tax on their investment earnings and deductible contributions when they make the conversion, those who convert in 2010 will have the option to spread the tax hit over two subsequent years: 2011 and 2012.

You probably know that a central tenet of tax minimization is to avoid them for as long as you possibly can. That allows your investment assets to compound and grow. So why am I so bullish on the Roth, which requires you to pay taxes now in exchange for tax-free withdrawals later on? There are a few key reasons. The chief one is that

future tax rates will very likely be higher than they are today. Not only does prodigious government spending make higher tax rates likely, but President Obama's economic platform during his election campaign included a plan to raise taxes for families with incomes of more than \$250,000. If you share the view that tax rates are apt to head higher in the future, it's better to pay taxes on your IRA assets at today's (knowable) rates rather than waiting to see what tomorrow's tax rates will be.

I also like the Roth because it adds another layer of diversification to many retirement portfolios. Just as spreading your assets among stocks and bonds, both foreign and U.S.-based, helps gird your investments amid varying market environments, so does it make sense to diversify the tax treatment of your retirement assets to help it withstand various taxation environments. For example, individuals who have a large share of their assets in a company retirement plan that will be taxed upon withdrawal, such as a 401(k), 403(b), or 457, should also consider stashing a portion of their retirement portfolios in the Roth, which offers tax-free withdrawals during retirement.

Last but not least, the Roth IRA also gives you more flexibility than you'll have with a traditional IRA. Notably, you won't be required to take mandatory distributions from a Roth at age 70 1/2, as is the case with traditional IRA assets. That's a huge boon if you don't expect to need your IRA assets during retirement; your IRA assets can compound and grow for your heirs. The Roth IRA also gives you more latitude than a traditional IRA to take withdrawals prior to retirement. If you convert to a Roth and five years have elapsed since you made the conversion, you can withdraw the converted amount, plus any additional

Continued on Next Page



Christine Benz,
Director of Personal Finance

Expert Q & A 6

**A Top Planner Shares
Wisdom for Retirees**

Portfolio Makeover 10

**This Boomer Is on the
Right Track**

contributions, prior to age 59 1/2 and you won't have to pay taxes or penalties.

As attractive as an IRA conversion can be, it's also complicated. Determining whether you're a good candidate for conversion depends on myriad factors, and the logistics of the conversion are also complex. I've received many questions about IRA conversions over the past several months, and I'll tackle some of them here. Ultimately, though, the decision about whether to convert is highly individualized, so I would recommend checking with an accountant or financial advisor to make sure you're thinking through all of the ramifications before you pull the trigger. Morningstar's IRA Calculator, available by clicking on the Tools tab of the home page, can also help you quantify your decision-making, as can the worksheet on T. Rowe Price's Web site. (I've included a list of resources at the bottom of Page 3.)

Q: I've heard there is a five-year waiting period to begin withdrawing assets once I've converted my IRA. I'm a 77-year-old retiree who's taking distributions from my IRA for living expenses. Does that rule apply to me, too?

A: No. It's true that those who are under age 59 1/2 must wait five years after making a conversion to begin withdrawing assets from their Roth IRAs. If you don't observe that five-year waiting period and you're under 59 1/2, you'll owe a 10% penalty on the premature withdrawal. If you're over age 59 1/2, that rule doesn't apply. You can take withdrawals at any time without incurring a penalty.

If you are younger than 59 1/2, the five-year waiting period begins on the first day of the tax year in which you made the conversion. For example, say you converted your IRA to Roth status in December of this year. If you're under 59 1/2, your five-year waiting period for those assets began on Jan. 1, 2009. If you convert additional assets later on, they'll be subject to a separate five-year waiting period.

Q: I've taken a look at the taxes I'll pay to convert my traditional IRA assets to a 401(k), and it's not pretty. Can I do a partial conversion?

A: Yes. Partial conversions are permissible and can be a great strategy, particularly if you've done the math and determined that converting all of your IRA assets will push you into a higher tax bracket for the tax year in which you convert. Partial conversions can also make sense if you don't have the cash on hand to pay the taxes associated with a full conversion. (Whatever you do, don't tap your IRA assets to help pay the taxes: You'll pay a 10% early-withdrawal penalty on any assets you don't roll into the Roth.)

Bear in mind, however, that you can't pick and choose which IRA assets to convert—for example, you can't convert all of your nondeductible IRAs and leave your deductible IRAs intact, although that would result in a lower tax hit because you've already paid taxes on those nondeductible contributions. Instead, the IRS considers all of your IRAs as one big pool when calculating your tax burden. Each dollar you convert will receive exactly the same tax treatment based on your aggregate IRA's breakdown between deductible contributions/investment earnings (taxable) and nondeductible contributions (not taxable).

For example, say you have \$100,000 in an IRA that's composed of \$30,000 in deductible contributions, \$10,000 in investment earnings, and \$60,000 in nondeductible contributions. In that case, 40% of every amount that you convert would be taxable upon conversion (that 40% encompasses deductible contributions and investment earnings), whereas you wouldn't owe taxes on 60% of your conversion (the percentage of your IRA portfolio represented by nondeductible contributions). Each subsequent conversion that you do would receive the same 40% taxable/60% nontaxable treatment.

Q: My wife and I don't have any IRA assets because we earn too much to qualify for a Roth IRA. Does this mean I can open a traditional IRA now and then convert to a Roth next year?

A: Yes. Individuals who earn too much to make a Roth contribution should consider making a nondeductible IRA contribution in 2009; they can then convert those assets to Roth status in 2010. Income limits on new IRA contributions will remain in place;

IRA Conversion Worksheet

In 2010, anyone will be able to convert from a traditional IRA to a Roth IRA, regardless of income level. The key differences between these two vehicles are as follows:

Traditional IRA

- ▶ Contributions may or may not be tax-deductible
- ▶ Tax-deferred compounding
- ▶ Taxed upon withdrawal in retirement

Roth IRA

- ▶ Aftertax contributions
- ▶ Tax-free compounding
- ▶ Tax-free withdrawals

You'll Need:

- ▶ IRA account statements, including information about the purchase price of the securities in your portfolio as well as the amount of deductible versus non-deductible contributions
- ▶ Expected income level in the current year

DETERMINE WHETHER A CONVERSION IS BENEFICIAL

	Beneficial for Conversion	Not Beneficial for Conversion
Have past contributions been deductible or nondeductible?	<input type="radio"/> Nondeductible	<input type="radio"/> Deductible
How many years do you have until you retire?	<input type="radio"/> 10 or more	<input type="radio"/> Fewer than 10
Do you expect to tap your IRA assets for living expenses in retirement?	<input type="radio"/> No	<input type="radio"/> Yes
Is your income lower now than it normally is?	<input type="radio"/> Yes	<input type="radio"/> No
Do you have a taxable estate?	<input type="radio"/> Yes	<input type="radio"/> No
Is there a chance you will need to tap your IRA assets prior to retirement?	<input type="radio"/> Yes	<input type="radio"/> No
Is the bulk of your retirement portfolio stashed in a traditional (non-Roth) 401(k)?	<input type="radio"/> Yes	<input type="radio"/> No
Do you expect your income to be higher in retirement than it is now?	<input type="radio"/> Yes	<input type="radio"/> No
Has your IRA account suffered significant losses over the past several years?	<input type="radio"/> Yes	<input type="radio"/> No

RESULTS

- If most of your answers fell under the Beneficial for Conversion column, that's likely the better option for you.
- If most of your answers fell under the Not Beneficial for Conversion column, you may be better off sticking with a traditional IRA than switching to a Roth.

ADDITIONAL RESOURCES FOR IRA CONVERSIONS

- The Conversion tab of Morningstar.com's IRA Calculator, available on the Tools tab.
- Fairmark's Guide to IRA Conversions: <http://www.fairmark.com/rothira/index.htm#conversions>
- IRS Publication 590: <http://www.irs.gov/pub/irs-pdf/p590.pdf>

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in 2010, single filers earning more than \$120,000 and those who are part of a married couple filing jointly that earns more than \$177,000 cannot make Roth IRA contributions. However, it will still be possible for those high-income earners to take a backdoor way into additional Roth contributions, by continuing to make nondeductible IRA contributions and then converting shortly thereafter. It's possible that Congress may close this loophole down the line, given that it doesn't make sense to leave the income limits in place for initial contributions but not conversions. But for now it looks like an opportunity.

Q: What if the government rescinds Roth tax treatment? Is there a possibility the appreciation in my assets will be taxed upon withdrawal?

A: There has been a lot of debate about this question, and, unfortunately, there are few clear answers. Almost anything is possible when it comes to the tax code, and I agree that the long-term trend in tax rates is likely to be upward. But you can take comfort in a few points. First, the Roth IRA has heretofore been a tax-sheltered vehicle targeted toward middle-income savers—contribution limits have kept out the highest-income earners. Raising taxes on middle-income earners is apt to come with significant negative political repercussions.

And in a worst-case scenario, if the tax treatment for Roth IRAs is rescinded, it would very likely only affect earnings growth on the investments, as Roth IRA contributions have already been taxed. That would be a bitter pill to swallow, of course, but not nearly as bad as paying taxes on the whole amount.

Q: I have assets sitting in my former employer's 401(k) plan. Can I earn Roth treatment?

A: Thanks to the Pension Protection Act of 2006, shifting those assets into a Roth is much like doing a conversion from a traditional IRA to a Roth. You'll owe taxes on all of the pretax assets in the plan at the time you make the conversion (Roth 401(k) assets aren't taxable). Beginning in 2010, individuals at all income levels will be able to roll over from a company retirement plan directly into a Roth; prior to 2010,

investors needed to have incomes of less than \$100,000 to do a direct rollover into a Roth IRA.

Q: I'm already retired. I've read that IRA conversions are particularly beneficial for younger investors, but how about for retirees?

A: Investors who have 10 or more years to retirement are the best candidates for conversion, because they'll have a good long time to recoup their tax hit. However, a conversion shouldn't automatically be off the table if you're nearing or even in retirement. If it's fairly early in your retirement, longevity runs in your family, and you won't need to put your hands on your IRA assets for five years or even more, a conversion may well be worth it because you'll have a good shot at recouping the tax hit.

Moreover, if you're already retired and taking Social Security, converting to a Roth could reduce the tax you pay on your Social Security income. Although the conversion could bump up the amount of Social Security benefits that are taxable in the year you do the conversion, the conversion could reduce your Social Security tax in subsequent years. That's because Roth distributions don't factor into the calculation that the IRS uses to determine which Social Security benefits are taxable.

You're also a good candidate for a Roth conversion if you've primarily made nondeductible contributions in the past, because you won't owe taxes on those nondeductible contributions—only your investment earnings and deductible contributions will be taxed upon conversion.

Finally, if you're concerned with estate planning and don't need to tap your IRA assets in retirement, the Roth offers a far better opportunity to defer taxes well into the future than does a traditional IRA.

Q: I've been hearing that a Roth IRA can be better than a traditional IRA from the standpoint of estate planning. Why is that?

A: There are a few reasons why. First, as I noted earlier, the Roth doesn't require mandatory

distributions, thereby allowing your assets to compound and increasing the amount you can pass to your spouse or heirs. Your heirs, in turn, will be able to receive tax-free distributions on those assets, and they'll also be able to accept distributions over an extended period, further stretching out the tax benefits and enabling those assets to compound on a tax-free basis.

The second key reason relates to estate tax. Because you've already paid tax on Roth assets, the overall nest egg that you pass to your heirs will be smaller under the estate-tax system, and therefore could help to reduce your estate-tax liability. The traditional IRA assets, by contrast, will be included in your estate-tax liability, even though your heirs will have to pay taxes on those assets. (Of course, the estate tax is another issue that will probably be revisited in Washington in the coming years.)

Q: I understand that if I convert my IRA to a Roth in 2010, I can spread the taxes over 2011 and 2012. But if I'm concerned about taxes going higher, wouldn't I be better off paying the taxes sooner rather than later?

A: That's a very good point. Deferring the taxes associated with the conversion carries its own set of risks, one of which is that income taxes could head higher in the future. But if you don't have the money to pay the taxes associated with the conversion in 2010, you'll have to weigh that against the threat of tax rates going up by the time you can pay them in 2011 and 2012.

Q: I haven't kept close track of how much of my IRA is in nondeductible and deductible contributions. Is there any way to find out?

A: You'll need to track down your past tax returns. As you do so, keep an eye out for Form 8606, which details contributions to nondeductible IRAs. Those contributions will not be taxable when you calculate the taxes due upon conversion.

Q: I think a conversion, at least partial, probably makes sense for me. But if my circumstances change, can I undo it? Is that what a recharacterization is?

A: Yes. Through what's called a recharacterization, it's possible to change the character of a Roth IRA to a traditional IRA, and vice versa; the process of recharacterization also allows you to "undo" your conversion from a Roth IRA to a traditional IRA.

A recharacterization can be an important lever if you convert your IRA and it turns out that the tax burden associated with the conversion is far greater than you had calculated, or if the conversion pushes you into a higher tax bracket and reduces your eligibility for tax credits and deductions. You'll also need to do a recharacterization if you convert your IRA but then determine that you weren't eligible to do so due to income limits—for example, say you converted your traditional IRA to a Roth in 2009 but you earned \$115,000, above the \$100,000 limit for conversions in 2009.

An IRA recharacterization can also help you avoid taking a tax hit at a time when your account is down. For example, say you convert your \$100,000 IRA in early 2010, triggering a \$25,000 tax bill. If the market subsequently goes down 30% and your account is worth just \$70,000, you can recharacterize your IRA as a traditional IRA. In that case, your account is still worth \$70,000, unfortunately, but you won't owe the \$25,000 associated with the conversion. You can then convert the lower IRA balance to a Roth at a later date, thereby reducing the taxes associated with the conversion.

IRA recharacterizations can be a valuable escape hatch, and they also allow for flexibility—for example, you can recharacterize part of your IRA assets rather than all of them. But they can also be complicated. If you think that a recharacterization makes sense for you, consult with a financial advisor or tax specialist who can help you think through all of the variables before proceeding. ■■

A Top Planner Shares Wisdom for Retirees

Expert Q & A | Christine Benz

The market environment over the past year has roiled all investors, but especially retirees, many of whom are questioning their game plans amid epic losses. To help provide guidance, I recently interviewed financial planner Mark Balasa, an Itasca, Illinois-based financial planner whose firm, Balasa Dinverno Foltz, manages more than \$1 billion in assets for high-net-worth individuals and families. During the course of our interview, Mark weighed in on asset allocation, taxes, and more.

Christine Benz: **After 2009, a lot of investors have been questioning the concept of long-term strategic asset allocation—buy and hold—and have begun thinking about being more tactical. How tactical should investors be?**

Mark Balasa: It's a great place to start because it's on so many people's minds. It's especially relevant for people who are at or recently moved into retirement, because people who were living right at the limit of what their assets would allow for have seen the market downturn permanently alter their course.

Philosophically, a lot of people over time came to the conclusion that a strategic portfolio with no tactical overlays was the safest bet—especially for do-it-yourselfers—because it's not as time-intensive or as involved as a more tactical strategy. Even some professional investors took that view.

But what happened during the market swoon last fall after the Lehman bankruptcy and through March of this year was that people, the press included, were saying, "Well, that wasn't smart to just hang in there. With a strategic allocation you got pummeled, and you should have been more tactical. You should have looked at different metrics in the market, different triggers, different valuation metrics, and so forth. Because all of these things were telling you that things were going to go from bad to worse, and look

at how much better off you would've been if you could've sold?"

If you fast-forward to today, to November of 2009, and you look back at the recovery since March 9, you see that the decision to be very tactical, especially if you raised cash or your bond allocation and you didn't come back into stocks, doesn't look so obvious now.

I still think that, for most people, a largely strategic allocation is the correct way to go. If you put 10% or 20% or 30% in some tactical approach, that certainly can help, but as we've seen over this past year, when it recovers, did your tactical play recover as well?

To what extent do you employ a tactical approach in your own practice?

Our strategic allocation is embedded with a tactical component. For example, our equity portfolio has a small-company and value bias. So we look different than the broad U.S. market or the broad global market. But that for us is strategic. On top of that, we will tactically overweight and underweight large versus small, value versus growth, both domestically and internationally.

What factors would you use to drive those tactical decisions?

For us, it largely comes back to valuations. Large growth versus large value, small growth versus small value, based on relative price/book and price/

earnings ratios. And then there's a momentum component: Which asset class has done well and for how long, and how does that look in historical context? And on top of that, we have essentially a gut call saying, "Yes or no, and to what degree?"

Do you have any trepidation about this? Because the landscape of managers doing truly tactical approaches well is...

Practically nonexistent. So the answer is yes, and that's why we don't make many changes. We might make one or two a year, we might go a year without making any. And when we do make changes, they're modest, for the reason you raise.

What are your current tactical positions?

We have a small-value bias, so we'd normally have 60% in value and 40% in growth, and right now we're 50/50—we're half growth, half value. So that's one example. Another one would be on the small-cap side. A neutral position for us is a roughly double weighting in small caps relative to what the market capitalization would suggest. And we're somewhere between a normal, marketlike weighting and a double weighting now.

“So the rule of thumb is a 4% or 5% withdrawal rate, and we know that's a safe number for most people. The challenge is that 4% doesn't do the trick for most people, unless you've got a lot of wealth.”

Are you wary of emerging-markets' valuations?

At the moment, the answer of course would be yes. But when you step back and look at the big picture, for the last year or five, and you look forward to the next five or 10 years, where is the growth in the world going to come from? Given the amount of debt and the demographics of the United States relative to the Brazils and the Chinas and the Indias of the world, and other Pacific Rim countries, where is the true growth going to come from on the equity side? So even though valuations in emerging markets have shot up like a moonshot since earlier this year, I certainly wouldn't eliminate my holdings. Maybe I wouldn't add to them right now, maybe I'd rebalance,

but over the next five to 10 years, it's hard to believe that that part of your portfolio is not going to grow in relative terms.

There seems to be this trinity right now, with everyone assuming there will be higher taxes, higher inflation, and a lower dollar—it's become such conventional wisdom that it makes me want to challenge it. What do you think?

Your point is a good one, because when everyone thinks something will happen, usually the opposite happens. But when you just look at the data and our country's current trajectory, it's hard to say that taxes won't go up. We don't have an immediate concern about inflation, with 10% unemployment and so forth, but a year and a half or two out, the potential for inflation—even strong inflation—is there. The dollar—given the trajectory of our spending, our deficits, our debt relative to GDP, and what the rest of the world thinks of that—it's easy to see why there's negativity about the dollar.

One topic that has gotten a lot of attention recently, especially in the wake of the bear market, is how to calculate an optimal withdrawal rate. How should retirees navigate that question?

Everyone aches for some kind of rule of thumb when it comes to spending. That's just how we're built as human beings. You take any specific couple or individual approaching retirement, and of course, everyone says, "How much in savings do I need? What's my number?" And when they do retire, they want to know, "How much can I spend?"

So the rule of thumb is a 4% or 5% withdrawal rate, and we know that's a safe number for most people. The challenge is that 4% doesn't do the trick for most people, unless you've got a lot of wealth. There are other approaches, where you ebb and flow the spending either based upon an inflation rate or a market metric of some sort. But all of those approaches are trying to come up with a generic answer to a question that has so many variables. What's your family history, in terms of longevity? What do you think tax rates are going to be? How many new cars do you want to buy? What do

you want to leave for the kids? And you see some very divergent views on this, by the way. Some people think, I put the kids through school and got them married, and darn it, I'm spending everything I've got. Others are determined that they want X amount left. That's a big influence on the decision. And, of course, people's views on those topics change. So you have all of these variables that can materially impact the actual answer for someone.

“I tell clients that just because you've settled on a withdrawal rate, that doesn't mean you can't exceed it in a given year.”

And, of course, when you do try to come up with rules of thumb, you're trying to solve for the lowest common denominator—in other words, the one that works the most often. But that might not be the right answer for a family where both sets of parents have died in their mid-70s, or the family has very specific goals about how much they want to leave for the kids. Those things, in my opinion, trump the rules of thumb.

I think one underrated factor in the withdrawal-rate discussion is that for most people, a flat rate is just not the way it works. Maybe you spend more when you're just retired, but when you're in your late 70s your spending might taper off.

You're absolutely right. What I usually draw on the whiteboard for clients is a horizontal line that breaks retirement up into three phases. You've got the first phase where you have a lot of health and energy. In the second phase, your energy and health might start to wane. And then you've got this final stage, which could be 10 days, it could be 10 years. But you're in really poor health and have a limited capacity to go out and spend. Each of these three phases has a different profile in terms of spending.

I also tell clients that just because you've settled on a withdrawal rate, that doesn't mean you can't exceed it in a given year: Say you have to buy a car, you want to take the grandkids to Disney, whatever it might be. It's still important to live your life, right? But in other years it's best to, as best you can, compensate for that. So many times people come in and say, "I can't

take the vacation this year with the grandkids because I'll go over my withdrawal rate." And I say, "Well no, we can still do that." If people are so myopic and rigid about adhering to some number, they sometimes make poor choices about the quality of life.

I did an interview with Ross Levin a few months ago and he asserted that most of his clients died with too much money, mainly because they had been overly conservative. Is that something you've run into as well?

Yes. It's the paranoia about not having enough. And you have to think about the generation that has passed away in the last 10 years; these are people who came through the Depression. In general, that generation was willing to defer gratification.

So in some cases it's a challenge for you to get your clients to spend what they can afford to spend.

Correct. But in some cases you have the opposite problem with people who are in their 50s or 60s right now. They didn't have that experience of living through the Depression so they want multiple homes, multiple vacations, big lifestyles—that's what you're fighting now, more so than not spending enough.

Can you discuss when you recommend that a client purchase long-term care insurance?

It's another loaded area in terms of people's view and philosophy about life. I'll give you a couple of examples. Mathematically, it's not that difficult to back into; you've got these retirement projections run for yourself, and you can quantify how much long-term care costs. The average stay in a nursing home is somewhere between 36 and 40 months, depending on whose numbers you're looking at. In Chicago, nursing home care costs \$6,000 to \$8,000 a month, so that's your number—that's what you need for long-term care, on average. So if the portfolio has that amount, above and beyond what you're spending, you can essentially make the argument that you can self-insure. But even for those who can self-insure, in practice, they may not want to spend the money on obtaining care, even though they can afford it and it's necessary. Again, attitudes on this are probably going

to vary by generation. Perhaps the younger generations aren't going to be so inhibited, but for some it's a big issue.

Let's talk about annuities, and the extent to which you think they're useful in client portfolios.

If you think about society in general, where people who live longer can use the assets from people who died earlier, annuities make sense. But when you break that down to the individual level, many people struggle with it. People wrestle with the idea that they are going to give their unused money back to the insurance company if they die. And number two—given what's happened to large institutions in the last year—the idea that your money is with the general fund of some financial company, and the risks associated with that, gives people pause about putting a lot of their money into an annuity. They might put 10%, maybe 20%. But saying to someone, "I think you should put half or maybe 80% of your money into a contract," you get the obvious pushback and I think that's legitimate.

Let's talk about the current income environment, and the extent to which you focus on current income for client portfolios. My guess is that you'll probably say not too much.

Bingo. We've all along focused on total return as opposed to current income, because when you focus on just the yield on something, you tend to get these disjointed portfolios that are either very interest-rate sensitive or have a lot of credit risk in them or call risk—you name it, it's there. So many times you'll talk to someone—especially if they're older, they'll come in and say, "I've got this stock, or this preferred, and it's yielding 12%. Why would we want to get rid of that?" And I'll explain that, "No, it lost 20% last year—your total return was -8%." And the response is, "I know, but the yield is great!"

So, from our perspective, if you manage for total return, the portfolio is more balanced and thoughtful, and you can also do a better job of managing for aftertax return because now we can get capital gains treatment and qualified dividend treatment as opposed to just income treatment.

I'd also like to talk about IRA conversions. It seems like it will be a great opportunity in 2010 for people who heretofore have not been able to do one. Are you pushing a lot of clients in that direction?

We're doing a lot of comparisons. Our approach is to be open-minded about it as opposed to having a bias for or against it, especially for people who have estate tax and other considerations in the mix—not necessarily income tax considerations. We're going to run these two different analyses to see not only if we should do it but in some cases equally important, how much should we do?

So what are the key factors that go into that analysis?

The first one for us is who's going to consume the asset? Is it going to be mom and dad, is it going to be their kids, or is it going to be the grandkids? So the longer the time frame for those assets the better, because a longer time frame gives compounding the chance to help us out. The next consideration is where are the taxes going to be paid from. It's not as appealing if we don't have any outside cash to pay the taxes, if it's got to come out of the IRA. It's better if we can take it out of a taxable account; that helps the math. Another consideration is, mom and dad's estate—is it taxable, or isn't it? If it's a taxable estate, that's another argument for paying the tax now, because you won't pay the estate tax on the income tax.

The idea of asset placement—and this gets a little more involved—here we try to put a client's high-returning tax-efficient things in their taxable account, and high-returning tax-inefficient things in their IRA account. Well, a Roth is an interesting animal, because depending on how the assets are configured across the balance sheet, between taxable and tax-deferred, you might have really high-returning things in the Roth—depending on who it's situated for—or you might have really just fixed-income things in there, depending on how the family's balance sheet is structured. So that one for us is something we're trying to spend more time on to see if there are any themes to focus on when talking to people, and then of course we're going to end up running the numbers for each family. ■■■

This Boomer Is on the Right Track

Portfolio Makeover | Christine Benz

Dean Stratton isn't your typical baby boomer. While there are mountains of data indicating that many born in the post-World War II era are profligate spenders who haven't begun to save enough for their retirements, his discipline and frugal lifestyle stand out.

At 57, Dean calls himself semi-retired. After a successful career in the communications field, he now covers his living expenses by working as an artist, and, less frequently, as a consultant in public relations. Although the bonds in his portfolio generate a nice income stream, he has not yet begun tapping the principal in his \$1.1 million retirement portfolio. While that amount, combined with his relatively young age, might set off alarm bells that he could outlive his assets, Dean's modest spending habits should give his portfolio staying power. He is currently living on \$35,000–\$40,000 a year, and his fixed expenses—including an \$800 monthly mortgage payment and a \$160 monthly premium on his health-insurance policy—are low. (Dean's wife, in her early 40s, is unemployed and the two haven't commingled their finances; the following discussion will focus on Dean's portfolio rather than the two partners' combined assets.)

At this life stage, Dean would like to determine whether his portfolio is sufficient to support him when he is fully retired. At that point, he will collect both Social Security and a small pension of roughly \$600 per month; he will look to his portfolio to provide the rest of his living expenses. Dean is also seeking advice on how to transition his portfolio into withdrawal mode. He acknowledges that he probably needs more bonds in his portfolio, but would also like to see his portfolio hit \$2 million before he retires—a tall order without holding the majority of his assets in stocks.

The Before Portfolio

Dean's is admirably streamlined: It includes just 12 mutual funds (a combination of actively managed and passive vehicles) and a \$243,000 laddered corporate-bond portfolio. Although Dean holds assets in both an IRA and a SEP-IRA (a retirement plan for self-employed individuals), the majority of his money is in his taxable account.

Dean's individual investment selections are solid, and the stock portion of his portfolio is well-dispersed across the Morningstar Style Box. But his equity position, at 74% of the total portfolio, is high given his age and life stage. He notes that he lost roughly \$300,000 during the market downturn from late 2007 through early 2009, though he also says that he has been pleasantly surprised by how rapidly his portfolio has rebounded over the past eight months.

The After Portfolio

Although Dean would like to see his portfolio scale the \$2 million mark, I'm concerned that may not be realistic without maintaining a very high equity weighting for the next decade or more. And there's also a possibility that holding an equity-heavy portfolio could work against him. While it's true that Dean doesn't have an imminent need to withdraw from his retirement portfolio, maintaining a very high equity allocation could also subject his portfolio to a very big market downdraft just before he begins withdrawing his assets—the worst of all worlds.

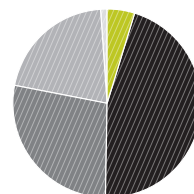
The conundrum for someone in Dean's position, however, is that bond yields are paltry right now and cash yields are almost nonexistent. Moreover, should inflation begin to pick up, interest rates could also shoot up in a hurry, thereby depressing the value of older bonds with lower coupons attached to them. For that reason, I'd recommend that Dean gradually add to his fixed-income and cash holdings, including a dose of Treasury Inflation-Protected Securities, over the next five years. I'd also recommend trimming those investments that are very volatile on a stand-alone basis, such as **Fidelity Leveraged Company Stock** FLVCX and **Vanguard Emerging Markets Stock Index** VEMAX. III

Dean's Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Corporate Bonds in 5-Year Ladder	N/A	N/A	242,661	N/A
Fidelity Diversified International FDIVX	★★★★	FB	197,147	1.02
Vanguard Emerging Mrkts Stock Indx VEMAX	★★★★	EM	109,404	0.32
Vanguard 500 Index VFINX	★★★	LB	105,547	0.16
Fidelity Leveraged Company Stock FLVCX	★★	MB	107,164	0.92
Vanguard Selected Value VASVX	★★★★	MV	100,245	0.38
Vanguard Total Stock Market Index VTSMX	★★★	LB	74,912	0.16
Vanguard Small Cap Growth ETF VBK	★★★★	SG	68,650	0.15
Hennessy Focus 30 HFTFX	★★★★	MB	43,357	1.27
Fidelity Low-Priced Stock FLPSX	★★★★	MB	29,459	0.98
Fidelity Growth Company FDGRX	★★★★	LG	14,606	0.96
Fidelity Select Brokerage FSLBX	★★★★	SG	13,146	0.89
Fidelity Canada FICDX	★★★★★	LB	11,297	1.00
Cash	N/A	N/A	15,000	N/A
Total			1,132,595	

Super Sector Weighting (%)	Top Three Sectors (%)
Information 18.00	Financial Svs 19.00
Service 42.00	Industrial Matls 14.0
Manufacturing 40.00	Energy 10.00

Asset Allocation (%)



- Cash 5.00
- U.S. Stock 46.00
- Foreign Stock 28.00
- Bonds 21.00
- Other 1.00

Equity Style (%)

Value	Blend	Growth	
21	17	19	Large
11	10	8	Medium
3	5	5	Small

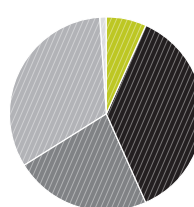
0-10 11-25 26-50 51-100

Dean's Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Corporate Bonds in 5-Year Ladder	N/A	N/A	242,661	N/A
Fidelity Diversified International FDIVX	★★★★	FB	197,147	1.02
Vanguard Emerging Mrkts Stock Indx VEMAX	★★★★	EM	50,000	0.32
Vanguard 500 Index VFINX	★★★	LB	105,547	0.16
Fidelity Leveraged Company Stock FLVCX	★★	MB	50,000	0.92
Vanguard Selected Value VASVX	★★★★	MV	100,245	0.38
Vanguard Total Stock Market Index VTSMX	★★★	LB	74,912	0.16
Vanguard Small Cap Growth ETF VBK	★★★★	SG	68,650	0.15
Vanguard Short-Term Inv.-Grade VFSTX	★★★★	CS	65,000	0.21
Vanguard Int.-Term Inv.-Grade VFICX	★★★★	CI	50,000	0.21
Vanguard Inflation-Protected Securities VIPSX	★★★★	GI	50,000	0.21
Fidelity Low-Priced Stock FLPSX	★★★★	MB	29,459	0.98
Fidelity Growth Company FDGRX	★★★★	LG	14,606	0.96
Fidelity Canada FICDX	★★★★★	LB	11,297	1.00
Cash	N/A	N/A	23,071	N/A
Total			1,132,595	

Super Sector Weighting (%)	Top Three Sectors (%)
Information 19.00	Financial 19.00
Service 42.00	Industrial Matls 13.00
Manufacturing 39.00	Consumer Goods 12.00

Asset Allocation (%)



- Cash 7.00
- U.S. Stock 37.00
- Foreign Stock 23.00
- Bonds 33.00
- Other 1.00

Equity Style (%)

Value	Blend	Growth	
22	19	20	Large
10	8	7	Medium
3	4	6	Small

0-10 11-25 26-50 51-100

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Categories

CI Intermediate Bond	LG Large Growth
CS Short-Term Bond	MB Mid Blend
EM Diversified Emerging Mrkts	MV Mid Value
FB Foreign Large Blend	SG Small Growth
GI Intermediate Government	IB Inflation-Protected Bond
LB Large Blend	

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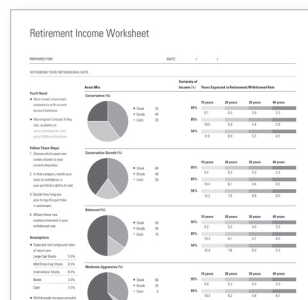
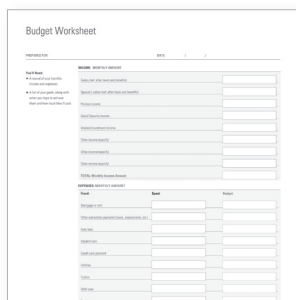
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