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Market Commentary

Happy 2010! New Year's is always a bit bittersweet affair for me—probably for you, too. It's a little like standing on a bridge between two shores. On the one side reflecting somewhat ruefully about the year gone by (opportunity grasped and missed) and on the other side the strong promise of a new year where opportunity will abound and I won't fail to grasp it. The new year is pregnant with possibility and I'm another year wiser. How can I miss!

* * * * *

In physics, the holy grail is the “unified theory” - a model that explains all of the physical universe in one simple elegant mathematical model. As I've participated in the markets over the last 26+ years I've lived through many market corrections and expansions and their corresponding economic precursors positive and negative. The vast majority of these I've looked at more as individual one off events than seismic shifts in the markets or world economies. They were momentary data points all operating within a broader long-term model. While these corrections could be

disturbing and needed to be managed around, they didn't necessarily change my “unified view” of the economic world.

In 2007, however, it dawned on me that the world bubble had burst and a deleveraging process had begun. This could be a game changer and perhaps the old unified model wouldn't work anymore. In that context I began to think about what has turned into the “Great Recession” as a multi-year event that unlike the corrections of the eighties and nineties would be more than a single event but a series of ups and downs within a longer time frame. In fact, sometime in 2009, I realized that the scope of the Great Recession might perhaps be even longer than the several years I envisioned; that most likely I should expand my mental picture backwards



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Special points of interest:

- Markets closed—Martin Luther King Day (1/18), Presidents' Day (2/15).
- Tax time! We will be sending out your 2009 Realized Gain/Loss Reports this month to help you prepare.
- Happy New Year! Time to schedule your annual financial review.

Fourth Quarter 2009 Market Wrap

<u>Market Indexes</u>	<u>% Change in Q4</u>
S&P 500	+5.5%
DJIA	+7.4%
NASDAQ Comp	+6.9%
MSCI EAFE	+1.8%
Russell 2000	+3.5%

<u>Mutual Fund Yardsticks</u>	<u>% Change in Q4</u>
Equity Income	+5.8%
Large Cap Growth	+7.1%
Balanced	+3.7%
Gen US Taxable	+0.5%
Intermediate Bond	+1.1%



Market Commentary (cont)

to include the 2000-2003 correction as the first breakdown that marked the end of the great 1981-2000 bull market.

So, the big picture or current “unified theory” in my mind is this—that the 2000-2003 correction marked a beginning of a decade long plus process and the current Great Recession needs to be viewed as a part of this long process, not as an event isolated from 2000-2003. It is possible that pressure built throughout the nineties as world economies changed (China vs. US, Europe vs. the world, emerging economies vs. mature economies) and an huge asset bubble was inflated by Central Banks starting in 1987. This led to asset bubbles and an unbalanced world financial system that began to correct in 2000 and continues to roll through the world today.

All this is by way of finally getting to 2010—because what we are likely to experience will probably be of a piece with the last decade. I believe that the 2010 markets should be viewed within the context of a US economy that is getting better because it has corrected some flaws and is moving forward on a firmer foundation because of it.

So within a bullish long-term mind set I think we can anticipate several items that need to be addressed.

Here’s my predictions for things to pay attention to in 2010:

1. Residential real estate will improve but remain sluggish.
2. Many commercial real estate loans were written at the top of the market in 2005-2007 with a 5-year balloon. If credit doesn’t pick up fast enough a lack of funding could collide with a huge loan rollover leaving many commercial properties unfunded and in default.
3. Many nations are closer to failures than we know (Spain, Greece, Abu Dubai, Russia) . Look for several failures to roll through the system in 2010.
4. US corporate profits improve and surprise on the upside, though not uniformly or universally.
5. Fannie Mae, Freddie Mac, and the FHA are currently absorbing most of the new residential mortgages being written. They are also insolvent and on Congressional life support. Look for one or more to disappear along with around \$400 billion of taxpayer dollars. Congress famously rolled the dice and came up with snake eyes.
6. Interest rates will continue to rise and the yield curve will further steepen.
7. The US deficit is a major problem at around 13% of GDP next

year (the aforementioned Greek debt is about 15% by the way) and has exploded in the last 16 months. The politicians will not do anything substantive about it in 2010. In fact, the runaway spending train will roll on. US total debt is fast approaching 100% of 1 year’s GDP—a level that we used to call “Banana Republic”.

8. State revenues are in dismal shape. This year will be the inflection point however because unlike the Federal Government, states can’t print their own money. States will be forced to balance their books and that combined with a slowly improving economy will put the states on a firmer footing for 2011.
9. Geopolitical risks are rising. Watch Iran, Yemen, North Korea, Venezuela, and Russia this year. The pressure is rising and must be resolved.
10. While there is a risk of double dip recession in the US (50/50?) I think we will escape it and make economic progress this year with GDP growth in the sluggish low single digits.

Growth will be sluggish because we will be working our way through the issues listed above on a rolling basis, but I do believe that we will be able to handle each as they arrive. ***You just can’t keep a great country down!***

MARKET TALK

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Report Card for 2009

I reread the Market Talk piece I wrote a year ago (Volume 12, Issue 1). I found it interesting, sometimes prescient, and that it contained (dare I say it) some “teachable moments”. So, in an effort to provide some wisdom and insight, I’ll take myself to task.

Market Talk, January 8, 2009: *“I think we are around half way through a difficult corrective recession, not a depression...I think that because we are simultaneously deflating a real estate bubble this will be of the longer and deeper variety.”*

The “Great Recession” that began in December 2007 seems to have ended (at least technically) in July or August 2009. I think I was right on the money with this one. The recession was severe, on the longish side at around 20 months and led to unemployment surpassing 10%. So far at least, it also has not led to the severe economic depression and 20-25% unemployment of the 1930’s.

Market Talk, January 8, 2009: *“Politicians will use a recession to gain their ends.”*

Correct, in spades. I think that all I need to do here is quote Rahm Emanuel, the Presidential Chief of Staff, “you don’t ever want a crisis to go to waste...”

Market Talk, January 8, 2009: *“I am constantly reminded lately of the Warren Buffet quote, ‘you don’t know who’s swimming naked until the tide goes out’...When things are going great a strong economy can cover up a lot of sins like imprudent banking practices, mortgages for homes that are really above the means of the borrower, Ponzi schemes, overly leveraged poorly managed hedge funds, over leveraged and morally bankrupt brokerages, etc.”*

Right, but I think if anything, I undershot on this one. Leading the list would have to be Bernie Madoff, the former head of the NASDAQ Stock Exchange and hedge fund operator who pleaded guilty to a massive Ponzi scheme in March of 2009. Multiple other smaller schemes surfaced throughout 2009 and we are still in the midst of the Raj Rajaratnam hedge fund insider trading case.

Needless to say, 100’s of banks failed last year and millions of homeowners are underwater on their homes and defaulting on their mortgages.

Market Talk, Jan 8, 2009: *“Oil pricing may remain surprisingly weak for a long time.”*

Yes, and no. Oil did indeed crash from a high of around \$150 per barrel in mid-2008 to a low just nine months later of only \$30/barrel. I believed that the recession would cap demand enough to subdue oil pricing at least through 2009. From the 1st quarter 09 low, however, oil rose steadily throughout 2009, settling into the low \$70’s to low \$80’s throughout the second half of the year. I was right on the crash in pricing, but wrong on the duration.

Frankly, I have been at a loss to explain the persistent seemingly high price of oil. Natural gas, for instance, crashed in price and remained stubbornly low throughout 2009. While I’m chalking oil pricing up to OPEC, a monetary bubble, the falling dollar, and trading pressures rather than fundamentals, I think that oil at \$80 given the current worldwide economic weakness is bullish for higher prices when the economy picks up and puts real end user demand on the commodity.

Market Talk, Jan 8, 2009: *“There haven’t been multiple bubbles, there has only been one over-inflated monetary policy... The over-inflation is still out there and I’ll say it simply right now—US Treasuries, particularly short-term bills and notes, are the current bubble. Look for them to fall in value and interest rates to rise.”*

I think I was basically correct and we’re still in the middle to early stages of that process. From the “flight to quality” **negative** T-bill yields of March 2009, interest rates - particularly on the longer end of the curve, have begun to rise (when interest rates rise, bond values fall) and the Treasury yield curve steepened noticeably in the last half of the year. On the longer end of the curve, the bond market leads the Fed and I think the market is telegraphing something important.

Market Talk, Jan 8, 2009: *“The economy*

Report Card for 2009 (cont)

will look pretty grim to you on Main Street for the next quarter or two, but don't necessarily couple that to the stock market...As the economic story plays out the market will be assessing whether the economy will be better or worse 6-12 months out. I think better."

Boy, did I get the "grim" part right! In hindsight, a year ago in early January we were just about in the middle of the real "meltdown" phase of the Great Recession. Things indeed looked grim and continued to get worse until some glimmers of hope began to emerge last summer.

What I failed to heed with enough conviction however, was my optimism for the future. The economic world did indeed look substantially more promising at the end of 2009 than it did at the beginning. And while the recession didn't technically appear to end until late summer, in hindsight the stock market low was March 9, 2009.

By nature I do tend to err on the side of caution with your money. Over the long term I think this has proved to be a demonstrably good thing. That instinct combined with unrelenting bad news and a less than perfectly economically stimulative political environment subdued my optimism through the spring and early summer. While I have steadily made strategic and opportunistic purchases and cash levels are down, I could have been more aggressive about that process. I've been here before though, particularly in 2003, and I firmly believe events will unfold to our long-term advantage.

Roth IRA Conversion by Russell M. Blodgett

Generally, traditional Individual Retirement Accounts (IRAs) offer current deductibility of contributions and income tax deferral of earnings on the account. When the owner of the IRA begins to receive distributions, presumably upon retirement, the distributions are taxed at the owner's current income tax bracket.

Roth IRAs offer no current deductibility of contributions. However, the earnings on the account accumulate income tax free. Upon retirement of the owner the receipt of Roth IRA distributions are non taxable provided they are "qualified distributions." Generally, distributions received following a 5-year period are qualified distributions if the owner is at least age 59 ½, disabled, or deceased, or if the withdrawal is a first-time homebuyer distribution.

Therefore, a Roth IRA offers the enticement of tax-free distributions when retirement arrives, whereas distributions from non-Roth IRAs are at least partially included in income. Converting a traditional IRA to a Roth IRA results in current taxation of the previously sheltered IRA balance. Deferring payment of tax is a traditional financial-planning goal. But with the recent economic downturn, the value of IRAs invested in equities is generally lower than in preceding years, and the tax cost of a conversion will be less. Future income tax rates may also be a consideration in whether to convert an existing traditional IRA to a Roth IRA. More than a few financial experts

expect income tax rates to rise significantly in the near term to help pay for the recent economic stimulus.

For 2009 and prior years, taxpayers whose modified adjusted gross income exceeds \$100,000 cannot convert traditional IRAs into Roth IRAs. For 2010 and later years, the \$100,000 MAGI ceiling is eliminated. In addition, for conversions in 2010 only, the income inclusion is deferred until 2011 and 2012. None of the converted amount is taxed in 2010; instead, half of it is included in income in 2011 and half in 2012. A taxpayer can elect out of the deferral and include the entire rollover in income in 2010. To prepare for this window of opportunity, high-income taxpayers should fund traditional IRAs by making nondeductible contributions or by rolling over amounts from employer plans.

In the past, two criteria had to be met for a traditional IRA to be converted to a Roth IRA:

1. The owner's MAGI could not exceed \$100,000.
2. The owner's filing status could not be Married Filing Separately unless the spouses lived apart all year.

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We are pleased to have guest columnist, CPA Russell Blodgett provide this article on Roth IRA Conversions.

Russ is a fellow professional working at 3240 Shelburne Rd, Shelburne, Vermont. A CPA since 1987, Russ focuses on individual and business taxation and provides accounting and financial management consulting services for a number of small businesses. Russ can be reached at 802-985-5570.

Before you make any decisions on Roth conversions we recommend talking to your tax professional.

Roth IRA Conversion (cont.)

For 2010 conversions, neither the MAGI limit nor the prohibition on separate returns for married couples will apply. Thus, all taxpayers will be eligible to convert or roll over eligible retirement account into Roth IRA accounts.

Conversion of a traditional IRA to a Roth account can be accomplished through a trustee-to-trustee transfer, a same-trustee transfer (if the same trustee maintains both IRAs), or a rollover that is completed within 60 days of the distribution. The amount removed from the traditional IRA is included in income in the year of the transfer. If the traditional IRA contained nondeductible contributions, Form 8606 is completed to determine the taxable amount.

If the entire amount in a traditional IRA is converted or rolled over to a Roth IRA, there is no early withdrawal penalty because there is no taxable distribution from the traditional IRA. But if the IRA owner retains part of the funds to pay the tax on the conversion, the amount that is not rolled over is taxable. The early withdrawal penalty applies if the owner is not yet 59 ½.

Each conversion or rollover amount has its own 5-year measuring period for qualified distributions. The 5-year periods begin on the first day of the conversion tax year (January 1 for a calendar-year taxpayer). If a distribution is made before the end of the 5 years, and before the owner is age 59 ½, the 10% early distribution penalty applies to the portion that is deemed under the ordering rules to come from the converted amount. The regular IRA penalty exceptions may still be used if they are applicable.

Several points should be considered in determining whether transferring other retirement savings to a Roth IRA makes financial sense.

- ◆ After the 5-year period ends, funds can be withdrawn from a Roth IRA at any time with no tax or penalty if the taxpayer is at least age 59 ½.
- ◆ There are no minimum distribution requirements from a Roth IRA.
- ◆ When the owner of a Roth IRA dies, the beneficiary can continue to receive distributions tax-free.
- ◆ If there is basis in the traditional IRA or employer plan, only the amount in excess of basis is taxed in the conversion year.
- ◆ Higher-income taxpayers continue to be excluded from making annual contributions to a Roth IRA, so a conversion is their only window to this account. Higher-income taxpayers can contribute to a Roth 401(k) plan if one is available.

Does it make sense for you to convert an existing traditional IRA to a Roth IRA? It depends on the make-up of your account. Do you have a large allocation of equities that may be valued less than in previous years? What is the level of your income and your corresponding income tax bracket? Are you currently eligible to make non-deductible Roth IRA contributions? What are your own predictions on how much our income tax rates will change? These are all additional factors to consider. Please consult your financial and/or tax professional for more guidance.



Lower Electronic Equity Trade Pricing

In its ongoing effort to make investing more accessible and affordable, Schwab announced reductions in online equity trade commissions designed to provide greater value for investors of all sizes, regardless of the frequency or size of their trades.

Beginning January 19, 2010, all clients will pay just \$8.95 per online trade provided that they are enrolled in eDelivery for trade confirmations and statements. Formerly, investors who held less than \$1,000,000 in household assets at Schwab paid between \$12.95 and \$19.95 per trade. Already over 1/3 of our clients have signed up for eDelivery. It is simple, painless and saves paper and money! If you are interested in taking advantage of eDelivery and reducing your trading costs, call us and we'll be happy to start the process for you.

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