

GUARDIAN

A PUBLICATION FOR THE CLIENTS OF PORTFOLIO STRATEGIES, INC.

Market Commentary

by Bill Whatmough, Senior Portfolio Manager

Year-End Rally Boosts Stocks

U.S. AND GLOBAL EQUITY MARKETS concluded a stellar 2009 with a strong 4th quarter, the third consecutive quarterly gain from market lows reached on March 9, 2009. Leading the way in the 4th quarter was the blue chip dominated Dow Jones Industrials, which gained 7.4% for the three-month period. The Nasdaq Composite, up 6.9%, and the S&P 500, up 5.5%, also recorded solid returns for the quarter. The small cap Russell 2000 tacked on 3.5%. For the full year, the Nasdaq Composite led the way advancing a stunning 43.4%, the Russell 2000 posted a 25.2% increase, and the S&P 500 23.4%. The Dow 30 Industrials trailed the other major averages, still up a solid 18.8% for 2009. Gains from the market lows on March 9 were mind boggling, with small cap stocks as measured by the Russell 2000 taking first place, exploding 82% from its lows; the Nasdaq (+79%), S&P 500 (+65%), and Dow (+59%) also recovered strongly. However, all averages finished well below their 2008 bull market highs.

All Clear for 2010?

Each New Year brings out the pundits in force, and we are amazed at how bullish the predictions have been for 2010. In one survey, over 80% of the analysts were predicting a higher stock market close this year. This, of course, after insisting all through the great rally over the past nine months that the next shoe is ready to drop and the recession is either ready to turn into a depression (early forecasts) or that the recovery will fail and we are about to re-enter the second leg of recession (later predictions). We get concerned when everyone turns bullish.

For the past 60 years, all of the recessions we have seen in the U.S. have been *inventory*

recessions that occurred when the economy got too far ahead of itself. Those recessions were worked off with the help of lower rates to stimulate spending so that growth could resume. The current recession is more of a *balance sheet recession*, where the economy has built up too much debt. Inventory also got a little too low, which is why we're seeing a bounce in the economy now, aided by huge amounts of government stimulus. However, a balance sheet recession cannot be corrected by increasing debt as our current economic advisors, the Fed, and Congress are attempting to do. They are simply adding fuel to the fire. While the stock market at the present is not indicating the current rally is over, the longer it continues, the greater our worries for its longer-term health. We think the all clear signal is premature.

Remember the Value of Diversification and Non-Correlation

Many of Portfolio Strategies' programs are no-to-low correlation programs relative to stocks, bonds, and other financial assets. Modern Portfolio Theory tells us that when several investments with similar historical returns and low correlation are combined in a single portfolio, the volatility of returns and/or risk of that portfolio is reduced dramatically. Investors often use the period at the beginning of a new calendar year to review their portfolios and make adjustments for the year ahead. We urge you to join them and make sure your portfolios are well diversified by including alternative asset classes to preserve capital should markets once again change direction.

Our thanks for your continued confidence in Portfolio Strategies; best wishes to you for a happy and prosperous New Year. ❁

Source for indices returns is FastTrack. Returns do not include reinvested dividends.



With the New Year come resolutions to improve our lives. Mostly, we resolve to take better care of our health—such as losing weight, exercising more, quitting smoking, etc., but what about taking the time to review our financial health.

If you're curious about whether you should open a Roth IRA, or switch your current IRA to a Roth, see the article on the reverse of this newsletter.

Now is the perfect time to review your portfolio and make adjustments for the year ahead. We encourage you to contact your representative to re-examine your investments.

John Williamson
Managing Partner

2010 Window Opens for Roth IRA Conversions

IN 2010, ANYONE, REGARDLESS OF INCOME LEVEL, may open or transfer funds from an IRA account to a Roth IRA, thanks to the Pension Protection Act of 2006. Prior to this year, only taxpayers with an Adjusted Gross Income of \$100,000 or less have been allowed to convert funds from their IRA into a Roth IRA.

With a Roth IRA, all contributions are after-tax (i.e. non-deductible); however, earnings from the account can be withdrawn free of federal income taxes once the individual reaches retirement. Earnings from assets transferred from an IRA account are not available for tax-free withdrawal until five years have passed since conversion and the account holder is at least 59½ years old. There are no minimum distribution requirements for a Roth IRA.

To convert existing IRA funds to a Roth IRA, taxes must be paid on any pre-tax IRA contributions, but there's another benefit to converting in 2010. For funds converted in 2010, the tax liability can be paid one half in tax year 2011 and half in tax year 2012. Convert in 2011 and taxes will be due on the full conversion amount for tax year 2011.



However, before you opt to convert to a Roth, you need to run the numbers. Although all earnings from a Roth IRA are exempt from federal income taxes, by paying taxes on all contributions in advance, you lose the earning power of those funds. You may also be paying taxes at a higher rate than you might if you held your IRA into retirement when your tax rate might be less.

Typically, a Roth conversion will make the most sense for individuals with years to go before they retire. The closer you are to retirement, the less value a Roth might have, unless your goal is to pass on the IRA to your heirs. There are no distributions required from a Roth IRA during your lifetime, and by converting to a Roth and paying the necessary taxes, you will shrink your taxable estate. That could mean bequeathing a pool of income-tax-free money to your heirs.

If you have an IRA in which after-tax contributions have been made, you only need to pay taxes on accumulated earnings to convert to a Roth IRA. ❁

These are Interesting Times

THE BEST PART OF A FINANCIAL CRISIS ARE THE NEW perspectives that arise as people look at where we have been and where we might be going. The information below is a collection of interesting insights. We're not sure where they will go, but we are looking forward to finding out the results.

- The three decades after World War II saw the rise of the middle class, whose income gains outpaced the gains of the wealthy. One reason may have been the top marginal income tax rates, which ranged from 70 to 91%. Did the wealthy have less incentive to make money, or did the high tax rates reduce the amount of capital they had to invest in wealth building?

- The recent period has been one in which considerable wealth was created not by the economy of producing and selling goods and services, but by selling assets back and forth. In the savings and loan crisis of the 1980s, institutions were selling commercial property back and forth to each other, making a profit on each transaction, even though no actual value was added to the property. Much the same took place in a more esoteric manner with collateralized mortgage securities. If this was an abnormal period, where do we go from here?

- Bull or bear? According to historical data and a still struggling economy, we may be in a cyclical bull market in a secular bear market, says Tom Lauricella in a June 15, 2009 *Wall Street Journal* article, "Is This Bull Cyclical or Secular?" If he is right, the market's run up in the 2nd and 3rd quarters is a temporary respite in a longer-term bear market.

- If you are feeling poorer, you are not alone. Net worth of American households (difference between assets and liability) at the end of 2008 was down nearly 18% from 2007, according to the Federal Reserve. Net worth fell another 2.6% in the 1st quarter of 2009, according to Fed data. Household liabilities are also on the decline, falling 2% in the 4th quarter and 1.2% in the 1st quarter of 2009.

- There's a lot of money sitting on the sidelines. According to ICI statistics, there was in excess of \$3.6 trillion in money market mutual funds in mid August 2009. That is nearly 24% of the value of U.S. equities, estimated at around \$15.2 trillion.

What this will mean to your investments remains to be seen, but with active management, PSI has the flexibility to respond to changes. And that can make all the difference. ❁

If you have questions about PSI or our programs, call your Representative or our office at (800) 959-2001.