Berkeley Investment Advisors

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Investment Newsletter – March 2014

Today marks the completion of a project to calculate precise returns for all our strategies. Below are the results for our Long Term Value strategy using an actual client account to calculate returns (net of fees). In the process we learned, as suspected, that our broker's return calculations are not correct. After reviewing returns, we explain how converting a traditional IRA into a Roth IRA can help stretch retirement saving by reducing long run taxes – in some situations.

Long Term Value Portfolio Strategy and Performance

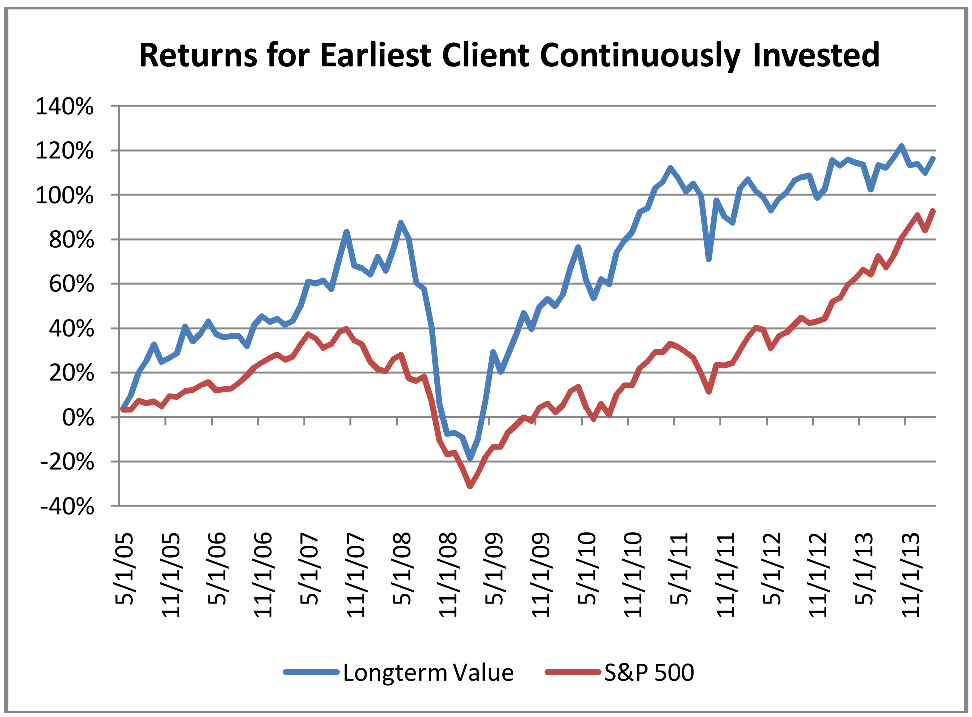
Berkeley Investment Advisors uses several different strategy portfolios to manage client assets. The Long Term Value portfolio is an equity strategy. This portfolio is meant for clients with a long term investing horizon who are willing to take moderate risk in pursuit of equity market returns (i.e. higher than fixed income returns). The objective is to earn returns at, or above, those available in the general stock market but with less downside risk. This portfolio is invested in exchange traded funds (ETFs), Real Estate Investment Trusts (REITs), stocks, and other equity securities.

We focus the portfolio on a relatively small number of stocks selected based on our assessment of expected long term returns. We make use of several independent research providers to help us indentify potential investments. The most important source is a screening tool that looks at companies with significant insider buying of their shares. On top of this, we layer our own valuation criteria and review financial statements to assess value. The goal is to find stocks that should produce returns of at least 10% annually.

Expectations of returns are based on how much the company is likely to earn, what this should imply for the future stock price, and the current market price. Since our projections for a given company change slowly, the current market price is the most important driver of changes in returns. As the current price rises, future returns are declining, and vice versa. Basically, we are comparing our assessment of value to the market price: we want to buy as the price drops below value, and we want to sell if price goes (too much) above value. It sounds sensible – buy low and sell high. But it means going contrary to the market. As the market rises, we sell many positions and it becomes difficult to find replacement stocks offering high enough returns to justify the investment risks. This leads to larger cash holdings when the market goes up to very high valuation levels as in the last year. This may cause us to earn lower returns in overvalued markets because we end up holding a lot of cash. Conversely, when the market declines sharply and more stocks fall below true value, we have a chance to use our cash to buy at prices that provide better returns over the long run.

In order to calculate returns for this strategy we selected the client who has had money in this strategy the longest and analyzed their account in great detail. To correctly calculate returns we must properly account for all money going into or out of the strategy, including dividends and fees. The return calculations here cover the period from April 30, 2005 to February 28, 2014, a period of almost 9 years. Over that time, the Long Term Value portfolio produced a cumulative return of **116.4%** compared to a cumulative return of 92.5% for the S&P 500 exchange traded fund. This return is calculated net of the 1.25% annual fee paid by the client. **So the portfolio return exceeded the benchmark by 23.9%.** This works out to about 1.4% higher return annually over the period.

The chart below shows the path of returns. As you can see there is quite a lot of volatility in returns. Excess returns were very high just after the market crashed – this provided us lots of cheap stocks to buy. More recently our returns are low relative to the market as it approaches record valuation levels. I expect we will outperform again during the market's next major decline and even more so subsequently. Patience is a virtue in investing.



Analysis of When to Move Retirement Savings to a Roth IRA

A Roth IRA is a type of IRA where you do not pay any taxes on the money when it is withdrawn from the account after age 59½ (and you held the account for 5 years). Although current tax law limits who can contribute to a Roth IRA, anyone can convert an existing IRA into a Roth IRA. When a regular IRA is converted to a Roth IRA, the converted amount is taxed in the year of conversion. If you are in a higher tax bracket now than you expect to be in when retired, the direct taxes on the money might be higher when doing the conversion. Therefore picking a low tax year for the conversion is important. In addition to the elimination of taxes on withdrawals, the other major advantage of a Roth IRA compared to traditional IRA is that there are no required minimum distributions (RMD) for the Roth IRA. In a regular IRA you would be forced to start taking distributions at age 70½ and RMD increases through time. This can cause indirect taxes to apply – meaning it could cause Social Security income to become taxable that would otherwise escape taxation.

I ran projections for various scenarios to determine when Roth Conversion would be beneficial. The biggest advantage is the case where you have a significant portion of savings outside of your retirement accounts and you want to use this to retire early – meaning before you're eligible for social security benefits. In this situation the best strategy is to spend first from your taxable accounts so that your retirement accounts have as much time as possible to grow tax free.

This strategy produces a number of years with very low taxable income followed by much higher taxable income as you begin to draw out money from a regular IRA. Such withdrawals count as ordinary income. Once social security benefits kick in you may find that the IRA withdrawals are causing a large part of the social security benefits to be taxed. The result is that the taxes reduce the length of time your money will last.

In this situation, what you want to do is recognize more taxable income in the years you are drawing from your taxable account by converting a portion of your regular IRA to the Roth IRA each year. The result is that you get to use some of the low tax bracket years to save on taxes you would have ended up paying later. This will significantly reduce the taxes paid on social security benefits in the later years. The result is that your retirement savings can last much longer.

I created a hypothetical example to estimate how much of a difference this strategy can make. My hypothetical couple is retiring when the husband is 60 and the wife is 55. They will take social security when he is 70 and she is 65. At retirement, they own a house worth $800,000 with a $500,000 mortgage. They have $500,000 in two IRA accounts and $550,000 of savings in a taxable account. Thus their net worth is $1,350,000. Besides mortgage and property tax, I'm assuming they will spend $54,000 per year in retirement. This is a modest lifestyle for California but they can always move to a less expensive house (or state) or work longer if they want to spend more on other things.

The key question is – how long will their liquid assets last? When they run out, they will not be broke, but they will need to pull money from the house by selling or refinancing. In the example given, without doing a Roth conversion, their money will most likely run out in 29 years - when he is 89. Looking at the probabilities of running out of money using simulation techniques shows that there is a 53% chance of still having money left when he is 87 (and she is 82).

Next I changed the scenario so that they converted $60,000 per year for each of the first 7 years in retirement from the regular IRA into a Roth IRA. This amount becomes taxable income but there is not much other taxable income in these years; the tax cost is only about 9.3% of the conversion. Because this eliminates future taxable income on a large part of their retirement accounts, they can manage their distributions to avoid paying any taxes once their social security benefits start. Over their lifetimes they end up paying much less tax and their retirement savings on average should last an extra 7 years. This scenario shows they will most likely run out of money when he is 96. They have a 61% chance of still having money left when he is 87.

These scenarios are completely hypothetical and I did not fully "optimize" their tax strategy. In reality each situation must be looked at in detail and the strategy carefully planned to make retirement savings stretch as long as possible. Our goal must always be to build in as much cushion as possible so that our later years can be worry free. For those retiring early with significant savings outside of their retirement accounts, a well planned conversion strategy can add a nice margin of safety.

Contact Information: RayMeadows@BerkeleyInvestment.com 510-367-3280