Berkeley Investment Advisors

Wall Street Expertise Working For You

Licensed by the California Department of Corporations as an Investment Advisor

Investment Newsletter – September 2010

Last month I had my 9 seconds of fame on CBS news. If you didn't see my quip about our low risk profile, check it out here: http://cnettv.cnet.com/bernanke-recovery-slowing/9742-1_53-50092270.html

This month we start with an analysis of Roth Retirement Accounts. After that we'll look at what's driving gold prices. Then we'll take a look at stock picking and the impact of rising stock market correlation.

Roth IRA's and 401K's

A Roth IRA is an individual retirement account from which tax free distributions can be taken (after the waiting period). There are also corresponding employer sponsored Roth 401k plans. As of 2010 limits on conversions for Individual retirement accounts have been removed. In addition the employer contribution portion of regular 401K plans can be converted to a Roth 401K - if you are age 59 ½ and have participated in the plan for at least five years, or if the money has been in the plan for at least two years. Of course your employer must have set up a Roth 401K plan for you to do such a conversion.

If you elect to convert from regular IRA or 401K you will pay tax on the amount converted. You have the option of counting the conversion as income in 2010 or splitting it between 2011 and 2012 and thereby paying the taxes later in two installments. If you take this option your taxes will be determined by the tax rates in effect in 2011 and 2012 – and your other income in those years.

The table to the right provides some analysis of the cost of paying conversion taxes in 2011 + 2012 instead of 2010. The deferral cost column shows the rate of interest you effectively pay to postpone tax to 2011-2012 tax years. This analysis assumes a $100,000 account conversion and other taxable income stays constant for years 2010 -2012.

Analysis of Roth Conversion Tax

Estimated Taxable Income	Annual Deferral cost	Avg. Tax for 2010 payment	Avg. Tax for 2011-12 payment
60,000	1.8%	24.9%	25.6%
80,000	4.3%	26.3%	28.0%
120,000	4.2%	28.0%	29.8%
130,000	3.6%	28.8%	30.4%
140,000	3.3%	29.5%	31.0%
150,000	2.1%	30.0%	31.0%
160,000	1.0%	30.5%	31.0%
170,000	1.3%	31.0%	31.7%
180,000	2.4%	31.5%	32.7%
190,000	3.3%	32.0%	33.7%
200,000	4.3%	32.5%	34.7%
210,000	5.3%	33.0%	35.7%
220,000	6.0%	33.0%	36.0%

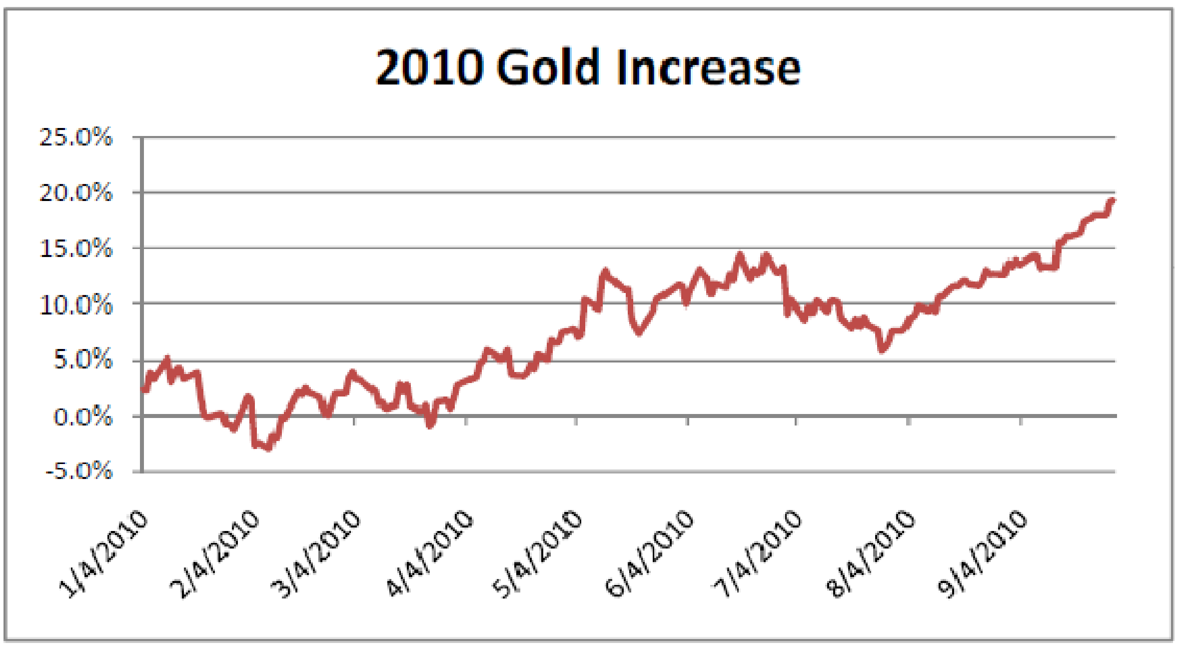
Based on this I would recommend deferral for anyone with regular taxable income below $220,000.

Note also that the table on the prior page shows the average tax rates you'll pay now to eliminate all taxes later. If you believe you'll be in a lower tax bracket in retirement then it doesn't pay to make the conversion. Of course there may be some risk to predicting taxes in the distant future and so the main benefit here is to convert some assets to reduce the risks of incurring much higher taxes in retirement than expected.

There is another more subtle tax benefit here. If you convert, you can pay the taxes with money currently invested in taxable accounts. This means you are effectively boosting your retirement accounts by the amount of taxes paid – which is far beyond the normal contribution limits for large conversions. For this reason I recommend not using the IRA itself to pay the taxes since this reduces the total tax benefit available.

The news out of Washington indicates that there may be a tax bill after the election. This could change the variables and so it may be worth waiting for that before deciding whether to convert an entire account or just part of an account.

Gold Prices



Gold prices have taken off in 2010 – up about 20% to $1,312 per ounce at the date of this newsletter. Supply hasn't changed much; increasing demand is driving gold higher. Gold is acting as an alternative currency here. The U.S. Federal Reserve Bank is creating money to buy government debt and push down interest rates. In doing so it decreases the returns from holding U.S. dollars and this, in turn, forces the currency value downward. At the same time, the European Central Bank is doing roughly the same thing to prop up the spendthrift governments there - which are on in danger of default. In Asia, China has pegged its currency to the dollar and they are riding it down – which is putting pressure on others in the region to depreciate their currencies to stay competitive. Japan, Korea, and Taiwan are all intervening in the currency markets to try to weaken their currencies in line with the U.S. The result is an entire world with a policy of reducing the value of paper currencies. In this environment, Gold is the only remaining store of value that it is not government policy to push down. As such, buying it serves as insurance against the potential disaster of massive currency depreciations.

All of this is the inevitable consequence of the real estate bubble and the government's decision to save the banks (and borrowers) by shifting their economic losses to others. So far the losses have mostly been covered by paying lower interest rates to savers and by borrowing on behalf of taxpayers. Japan did exactly the same thing after their real estate bubble burst. That policy has led to economic stagnation and declining income and wealth in Japan. But Japan was different in that it had a much larger pool of domestic savings that it could pay low returns on. In the U.S. we borrow savings from foreigners. If the Federal Reserve pushes down interest rates, foreigners will need the dollar to appreciate to make up the difference compared to their own interest rates. Since the dollar is already over valued on a competitive trade basis they need the dollar to decline until it reaches a point where foreigners can expect to earn enough appreciation going forward to make up for the low interest rates. The risk of massive dollar over-supply and depreciation is thus driving a lot of the smart money into gold to protect capital.

This result looked likely more than 2 years ago. We bought gold and gold mining companies in April 2008 when gold was around $900 per ounce. This could run much further so we'll hang onto our gold until the dollar runs its course downward or we see changes in government policies.

Stock Picking and Correlation

These are somewhat frustrating times for those of us who have historically enjoyed earning excess returns from picking individual stocks that were undervalued relative to the market. The problem comes down to a technical term called correlation. This is a statistic that measures how things move together. If its 100% they are moving exactly in unison. If it's 0 their movements are completely independent of one another. So high correlation of stocks means that they all tend to move up together and move down together. In normal times correlations tend to be moderate to low. A recent Barclays Capital research piece calculated correlation of U.S. stocks at 27% on average for 2000 to 2006.

If you pay attention to different companies you quickly realize that there are very significant differences in their performance depending on quality of management, business model, and various specific attributes that generate good or bad results. Given this diversity of fundamental value drivers, over time we will see vastly different earnings results and big changes in the relative value of various companies. When we see high correlation and the good companies moving in step with the bad, it implies that some stocks are too expensive and some are too cheap. An obvious implication is that a declining market with high correlation will lead to bargain stocks – because investors following the herd will be selling everything. This is good for a stock picker.

Historically we have seen correlations rise dramatically in a big sell off. Barclays Capital reported that correlations spiked to 80% between October 2008 and February 2009 before falling to the 40% level during last year's market rally.

The problem is that while high correlation presents us with buying opportunities, in order to earn excess returns over the market, we require that our stocks perform differently than the market – i.e. we require lower correlation going forward. When this happens, the market rewards us for correctly buying the most under-valued stocks. Unfortunately correlation has moved higher. In mid August it was 74% and has pulled back just a bit over the past months. Such episodes of high correlation will tend to dampen any potential for out-performance by stock pickers such as Berkeley Investment Advisors. (This goes double for us because we are hedged eliminate market risks and returns; we expect our returns will be just the excess return of our picks over the market.) Thus high correlation is giving us very low returns until things go back to normal.

Our stock picking strategy tends to outperform over the long term because in the end fundamentals will end up driving the stock price. The challenge right now is that the growth in trading via Exchange Traded Funds (ETFs) and the huge share of passive (dumb) money in the market tends to drive up correlations in general. We need this for buying opportunities but the downside is that we require ever more patience to wait for the market to differentiate and reward our stock picks with higher prices. This brings to mind an old saying about outperforming the market using a value strategy – **"it's simple but it sure isn't easy".**

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