Wealth Management

KANE COMPANY

A FEE-ONLY REGISTERED INVESTMENT ADVISOR

Certified Public Accountants and Financial Advisors

Kane Company, P.C. 515-270-2727 Spring 2010

Bear Markets Are Good For Long-Term Investors

This is a great time to be young—particularly if you have the means and the foresight to invest in the stock market and the patience to let your investments work over time. Though the bear market has scared off many would-be investors, putting money into stocks during and after a downturn has historically been a winning strategy, according to a study by investment company T. Rowe Price. Long-term investors who systematically invest in equities during a bear market are actually better off than those who start investing during bull markets.

The T. Rowe Price study focused on four hypothetical investors. One began investing in 1929, another in 1950, the third in 1970, and the last in 1979. Each "investor" put $500 a month into a portfolio that replicated the performance of the Standard & Poor's 500 stock index for 30 years. The study assumed a $10 share price at the beginning of each period, and all dividends were invested in additional shares.

Two of the hypothetical investors—the one who started investing in 1929 and the other who began in 1970—entered the stock market just before two of the worst bear markets in history. During the decade of the Great Depression, from 1929 through 1938, the S&P 500 had a negative annualized total return, losing almost 1% per year, and the 1970s were only slightly better to stock investors, with the S&P averaging a 5.9% annual total return during years of exceptionally high inflation that reduced the value of market gains. Yet the investors could take solace from three positive factors during those dark days.

1) Investing during a bear market, they were able to buy shares of stock at depressed prices, and that let them accumulate more shares than they could have if prices had been higher. This positioned their portfolios for outsized gains when stocks recovered.

2) By dollar-cost-averaging—making regular, equal investments regardless of whether the market was up or down—and reinvesting dividends, the two investors who started during the bear markets would have posted small gains after the first decade. They would have done better than investors who had narrower portfolios or who had invested their money as a lump sum rather than as a series of periodic investments.

3) Compared with the two other investors, who accumulated fewer shares at a higher average cost during the rampaging bull markets that began in 1950 and 1979, the bear market investors fared much better after 30 years. The advantage of the investor who began in 1970 was particularly pronounced, thanks to stocks' exceptionally strong performance during the 1980s and 1990s.

For the 30 years beginning in 1929, the S&P 500 provided a decent 8.5% annualized return, rewarding that

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Kane Company, P.C. Is Now Online!

We are excited to announce the launch of our website at www.KaneCompanyPC.com. While visiting our website, you can find information on the wide range of services that we offer, learn more about the funds and investment strategies available through Dimensional Fund Advisors, read our quarterly newsletters, and log into your TD Ameritrade Institutional account. Check it out today!

Please note that we now have new firm wide email addresses effective immediately. Update all of your email contact lists and use the following email addresses to contact firm personnel:

Steve@KaneCompanyPC.com
Elizabeth@KaneCompanyPC.com
Sarah@KaneCompanyPC.com
Susan@KaneCompanyPC.com
Lori@KaneCompanyPC.com

In tax-related news, remember that the First-Time Homebuyer Credit has been extended and expanded to include long-time residents. If you purchase or have entered into a binding contract before May 1, 2010 to purchase the property by July 1, 2010 then you are still eligible for the credit. There are income limits and residency requirements for long-time residents, so contact us to see if you qualify.

If you haven't contacted us to prepare your 2009 tax return, there is still time. Please call our office to schedule a meeting or stop by with your source documents so we can prepare your return or file an extension by April 15.

Steven L. Kane, CPA/PFS, CFP®

Splitting Up Your Roth IRA Conversions

What may be an optimal time to convert a traditional IRA to a Roth IRA has arrived. Beginning in 2010, high-income taxpayers qualify to make the switch, and for some, the basic trade-off of a conversion—paying income tax now in return for tax-free income during retirement—could be worthwhile. As an added incentive, taxes on conversions made in 2010 can be paid during the following two years. Yet with markets unsettled, a conversion could backfire, leaving you to pay income taxes on assets that have lost value after the transfer to a Roth. Establishing multiple Roth IRAs, rather than just one, could give you the flexibility to minimize the damage.

By splitting up a converted Roth, you avoid having to make an all-or-nothing choice about whether to "recharacterize" the account back into a traditional IRA. The IRS gives you that option, allowing you to undo a conversion and avoid the associated taxes. But you can't do a partial recharacterization, returning only selected assets to the traditional account.

That's the benefit of establishing multiple Roths. You might use one account for stocks, for example, and a second for non-stock investments such as bonds. Then, when it's time to file your tax return for the year of the conversion, you can look at the investment performance of each account. If stocks have fallen while bonds were positive, you might decide to recharacterize the stock Roth IRA but leave the other alone. In fact, rather than just creating two Roth accounts, you can go even further with this technique, subdividing the "stock" account by industry sectors or capitalization.

The old rule for conversions, which required an adjusted gross income of $100,000 or less, is eliminated in 2010. But those who choose to convert a traditional IRA to a Roth IRA will still owe income tax on the converted amount that's attributable to tax-deductible contributions and earnings. (Non-deductible contributions are exempt.) That tax is particularly painful if the value of account investments has fallen sharply, and many account owners who converted early in 2008 undid the conversion after the stock market plummeted later in the year. You have until your tax return due date, plus extensions, to change things back to the way they were.

By splitting your assets into separate accounts, you can wait to see how each account performs. The earlier in the year you make the conversion, the longer you'll have to make a final decision. For example, if the conversion took place on January 1, 2010, you have until April 15, 2011, to decide about a recharacterization—or until October 15, 2011, if you elect an extension.

What if you determine that future investment performance will improve for that asset class you just recharacterized? You can "reconvert" your traditional IRA to a Roth, but not until the start of the following year or 30 days after the recharacterization, whichever comes later. ●

Convert Your 401(k) To A Roth In One Step

A recent pension law change simplified the rules for rolling over assets from a 401(k) plan to a Roth IRA, and another change in 2010 means almost anyone can make such a move. You can now accomplish your objective in one move, instead of the two steps previously required, and that could make this a convenient way to guarantee tax-free income during retirement.

If you participate in a 401(k) plan at work, you get to defer part of your pre-tax salary to your account. You can generally contribute up to $16,500 to a plan in 2009 and 2010 ($22,000 if you're age 50 or over). In addition, your employer may make matching contributions up to a maximum percentage of your salary. Account investments grow without being taxed, and there's no tax due until you begin taking distributions from your account. Those withdrawals are taxed as ordinary income. Although there's normally a 10% penalty tax on withdrawals before age 59½, you may qualify for one of several exceptions (for example, early retirement at age 55).

One way or another, you have to pay the piper one day on the money in your 401(k). But you may be able to absorb the income tax hit now, by converting your account to a Roth IRA. Though the amount you convert will be fully taxed—assuming it consists entirely of tax-deferred contributions and the investment gains attributable to those contributions—later distributions from the Roth during retirement normally aren't subject to any taxes.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to transfer funds from a 401(k) plan to a Roth IRA (assuming your employer plan permitted such transfers). First, you had to roll over funds to a traditional IRA, a transfer that's exempt from tax liability if completed within 60 days. Next, you had to

Best Times Often Followed Worst Times

These have been tough times for strategic long term investors. While it may seem logical to stay the course through the market's inevitable ups and downs—taking advantage of stocks' tendency to deliver strong returns over very long periods—that logic was little comfort during the bear market, when some portfolios lost more than half their value. Wouldn't it have been better to bail out in, say, late 2007, replacing stocks with cash or with bonds, which have outperformed equities during most of this decade?

Of course it would have been better, but myriad problems stand in the way of executing a successful market timing strategy, which calls for getting out of investments before they swoon and getting back in when they're ready to rise. To investigate market timing's feasibility, Donald Bennyhoff and Yan Zilbering at the Vanguard Group recently examined the performance of the Standard & Poor's 500 stock index from 1928 through 2008 and reported their results in a research note, "Market-Timing: A Two-Sided Coin." Looking only at prices—they left aside dividends because of a lack of data on daily total returns before 1980—Bennyhoff and Zilbering found that the index had returned an average of 5% a year during that 81-year stretch. A clairvoyant investor who had managed to be out of the market on just the 20 worst trading days—avoiding an average loss on those dark days of 9.2%—would have gained 7.5% annually. Anyone who had missed the 20 best days, on the other hand, would have gained only 2.6% a year. That amounts to a 50% swing, up or down, in portfolio performance.

No one could ever hope to forecast all of the market's best and worst days. But given that infinitesimally small changes—being out of the market on just 20 of 20,340 trading days during the 81 years the researchers considered—can have a profound impact, it may seem worthwhile to try to identify some of them. What if, for example, you got out of the market after it had a particularly bad day, or got in after a really good one? Wouldn't more of the same be likely to follow?

Often that's not the case, according to Bennyhoff and Zilbering. Frequently the best and worst days happen within shouting distance of one another, and some of the best days have been particularly likely to follow hard on the heels of some of the worst. In dramatic turnarounds, eight of the 20 best days occurred within 10 trading days of one of the worst 20 days. On October 29, 1929, the S&P sank by 16.1%; the next day, it soared 12.5%. In 2008, a 7.6% loss on October 9 was followed by an 11.6% gain on October 13.

Post-plunge rebounds often last more than a day, with the market frequently recouping, during the next few weeks, a significant fraction of what it has lost. For example, the worst sell-off in the Vanguard study—on October 19, 1987, when the S&P 500 lost 20.5% of its value—was quickly followed by a lot of buying. Within 20 trading days of Black Monday, the market had rebounded by 9.6%. A similar thing happened during the 1929 crash; after that 16.1% free fall on October 29, the S&P stabilized temporarily, regaining 2.5% during the 20 trading days that followed. And in 2008? Twenty days after December 1, when the market fell 8.9%, it had regained 9.1%. Looking at the S&P's performance following all 20 of the worst days, the market regained an average of 2% during the next 20 trading days.

For would-be market timers, those tendencies make a difficult job virtually impossible. While it may be feasible to anticipate broad market shifts and to make tactical adjustments to a portfolio based on certain metrics like price-to-earnings ratios, any attempt to time a wholesale market entrance or exit will probably fail. Few people expected the stock market to surge when it did in the spring of 2009, or to advance as much as it did during the next several months. Investors who had cashed out their portfolios during the market rout almost certainly missed some (if not all) of the rally.

The recent volatility of the S&P 500—from day to day, week to week, and month to month—only reinforces how unlikely it would be for anyone to get in or out at just the right time. Rather than try to time the market, which almost always backfires, most investors would do better to stick with a well-diversified portfolio with regular asset allocation rebalancing to keep volatility in check and increase potential long-term gains. ●

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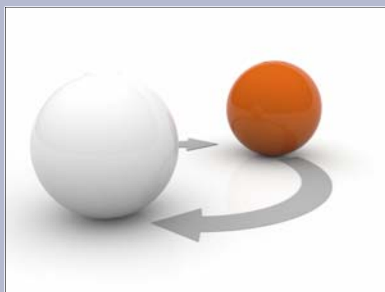
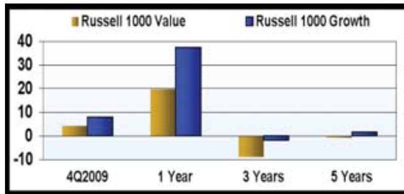
convert the traditional IRA to a Roth IRA and pay the resulting tax. To further complicate matters, Roth conversions had previously only been allowed in a year in which your adjusted gross income is $100,000 or less.



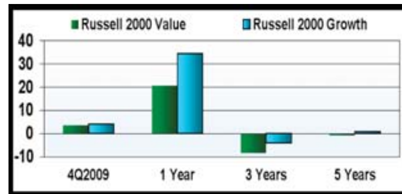
Now, these strict rules have been loosened. Under the PPA, you can transfer 401(k) assets directly to a Roth IRA. This change applies to distributions made after 2007. What's more, as of January 1, 2010, the $100,000 ceiling no longer applies, and for conversions in 2010, you can spread out the tax you owe over the following two years.

The IRS has also issued guidance allowing tax-free 401(k) transfers to a Roth IRA of up to the amount of after-tax contributions you may have made to your employer plan (Notice 2008-30). That could be better than a two-step transfer, because when you convert from a traditional IRA to a Roth, the tax-free amount is limited to a pro-rated portion of nondeductible contributions to all of your IRAs. With a one-step transfer, it doesn't matter what's going on in your other retirement accounts. ●

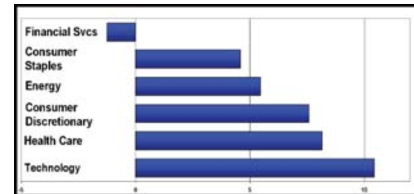
Market Data Bank: 4th Quarter 2009



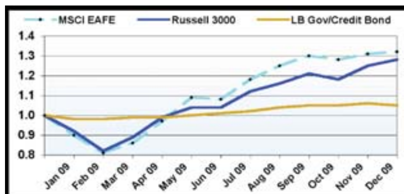
LARGE VALUE VS. LARGE GROWTH
Although the rally that began in March lost momentum in 4Q09, growth-oriented investors in particular still enjoyed substantial gains. Large growth added 7.94% in 4Q; large value gained 4.22%



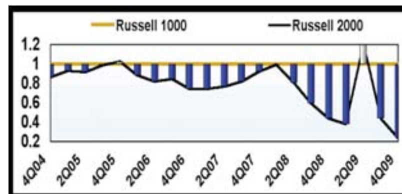
SMALL VALUE VS. SMALL GROWTH
Signs of a broad-based economic recovery proved elusive in 4Q09, curbing the performance of the small-cap companies that have historically outperformed in the wake of a recession.



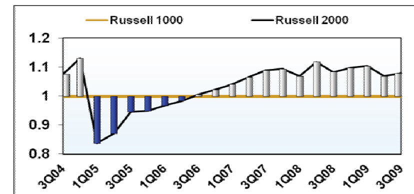
THREE BEST AND WORST SECTORS
As the economic tone wavered, investors rotated their funds to capture pockets of relative growth in the technology, health care, and retail sectors, while limiting their exposure to still-fragile bank stocks.



FOREIGN, US STOCKS & US BONDS
Renewed tolerance for risk translated into roughly a 30% full-year gain for both US and foreign shares. Demand for Treasury debt waned in 4Q09 but bonds still ended a volatile year in positive territory.



LARGE VS. SMALL STOCK EARNINGS
Even though the recession's destructive force faded in 4Q09, corporate profits remained under pressure. Large-cap earnings contracted 12%; small-cap results proved somewhat more resilient.



PRICE-TO-EARNINGS RATIO
After rallying for months, high-quality stocks ended 4Q09 priced at close to fair value. Small companies continued to fetch a higher premium on a profitability basis, reflecting hopes for growth ahead.

Small-cap stocks represented by Russell 2000 index, large-cap stocks represented by Russell 1000 index. Foreign stocks represented by the Morgan Stanley Capital/ International's Europe, Australia, Far East Index, and US bonds by the Lehman Bros. Government/Corporate Bond Index. P/E ratios exclude negative earnings. Small-cap stocks tend to be more volatile than large-caps. Bonds offer a fixed rate of return while stocks will fluctuate. Indices are unmanaged and do nott represent any specific investment. Foreign investing involves special risks, including political unrest, economic instability, and currency fluctuation. Past performance does not indicate future results.

Source: Russell/Mellon

Bear Markets Are Good

(Continued from page 1)

period's systematic investor with a total return of 960%. Even more impressive, the investor who began in 1970 would have earned a 1,753% total return during the next three decades. And the investors who started during bull markets? Each earned total returns of less than 400% during 30 years of investing, according to the T. Rowe Price study.

The bear market investors thrived because they began when times were tough, rather than despite that apparent misfortune. To prove that point, the study also examined what would have happened if the first two decades of each period had been reversed—so that, for example, the tough sledding of the 1970s had been preceded by the strong market performance of the 1980s, rather than followed by it. An investor beginning $500 monthly contributions in 1970 would have had $589,707 after two decades—but only $358,972 if the decades had been reversed. That was true even though, in both cases, the S&P 500's annualized return for the 20-year period would have been an identical 11.5%.

Investing in the stock market during a bear market—and during the hard economic times that led to the downturn—requires a leap of faith for new wage-earners as well as for older investors stung by recent losses. But down cycles for stocks and the economy have always been followed by rebounds, and equity markets tend to recover months in advance of a return to economic growth. As the T. Rowe Price study shows, it can pay to take advantage of those trends by beginning a program of long-term, systematic investing just when conditions seem worst. That's a lesson even middle-aged investors could take to heart as they look to regain their investment footing after the historic market plunge.

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Steven L. Kane, CPA/PFS, CFP® **Kane Company, P.C.** **5526 N.W. 86th Street, Suite A, Johnston, Iowa 50131**
phone: (515) 270-2727 **fax: (515) 270-1509** **email: KaneCompany@kanecompanypc.com**

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