DAVIS INVESTMENT GROUP

Registered Investment Advisor Firm

©ISSUE III, VOL. IV – *Bud Heng – Registered Adviser (925) 360-6819*

MARCH – 2015

Diversification

Since the market bottom of March 9, 2009, the markets have come a long way. There have been hot sectors and cold sectors and just about everyone's opinion as to how bonds, Treasuries in particular, would perform were just flat wrong.

Diversification remains the cornerstone of Modern Portfolio Theory (MPT), yet during the 2008 – 2009 market drawdown "diversified assets" all followed the markets down. This caused many investors to question the utility of MPT.

MPT advocates that investment portfolios are best constructed when they combine a wide variety of uncorrelated assets. This should then reduce the overall volatility and market "risk" of the portfolio.

Unfortunately many investments are highly correlated with equities and legacy naming conventions of investment classes like large cap, small cap equities, government, corporate bonds, commodities, real estate, foreign established and emerging markets, etc. These may actually mask your ability to construct a truly conforming portfolio based on MPT concepts.

One is forced to look backwards in order to construct a MPT based portfolio solely based on past performance, which we all know is no indicator of future results.

However difficult the task, MPT and diversifying your investments still remains one of the key concepts to successful investing.

So unless or until someone invents a better mouse trap, try to stick with diversification to protect your portfolio over the long-term.

Taxing Estates

Not that any of you plan to permanently retire anytime soon – as in stop breathing, I thought I'd briefly discuss this subject in light of the President's proposal to eliminate the stepped-up basis for inherited assets.

Currently if you inherit a stock that was purchased for $20 fifteen years ago and is currently worth $100 per share, your basis (cost against which capital gains would be calculated should you elect to sell it) would be the value per share on the date of death of the person from whom you inherited the stock.

In this case it would be $100 per share and if you elected to sell the stock while the price was still $100, you have no capital gain tax owed or due.

If the proposal gains traction and is implemented, your basis would be $20, the value as of the date it was originally acquired and if you sell at $100, you would owe capital gains on the $80 difference.

I wasn't able to find reliable numbers for 2013, but for 2012 only a small number of estates owed any tax at all. This was mostly a result of the individual exemption being $5 million, up from $675,000 just 12 years earlier.

For 2012, there were 9,404 returns for estates worth less than $5 million, that year's individual exemption, but that doesn't mean the IRS ignored the returns. The IRS audited 1,362 of those returns, a 14.5% audit rate. The result of those audits was a recommendation to collect an average additional tax of $85,718 per return.

Larger estates drew even more IRS scrutiny. For estates worth between $5 million and $10 million, the audit rate was 58.6% of those returns. This resulted in a determination that the heirs still owed an average of $105,388 per return, in addition to taxes already paid.

In an interesting twist of math, there were just 937 returns that year for estates worth more than $10 million, and those 937 returns resulted in 1,087 audits. The excess was the result of repeated examination of the audited returns and on average the heirs were asked for an additional $819,243 per return.

The takeaway as this year's tax season ramps up are twofold: 1) The higher the net worth, the more important it is to create an estate plan that can withstand careful scrutiny; and 2) A solid estate plan can offer tax benefits via strategies that work to reduce estate value, shelter estate value and shift future appreciation between now and the second spouse's death out of the estate.

Competent attorneys are vital to crafting estate plans, but a financial professional's input can be just as critical to make sure the estate plan and financial plan work in concert in the context of someone's overall financial plan.

Answer Forum

One of my readers (you know who you are) was kind enough to ask about converting a traditional IRA to a Roth IRA and wanted greater detail and guidance to help with the decision making process.

There are some general rules of thumb that one can follow, and each requires an assessment based on your own circumstance.

First, make sure you won't need any of the converted funds for at least 5 years. Second, will you expect to be in a higher tax bracket in retirement than you currently are? Third, make sure you can pay the taxes related to the conversion from funds other than IRA funds withdrawn for conversion. Fourth, because there are no mandatory required minimum distributions, you will not need the funds for retirement and wish to pass them to your heirs.

It doesn't end there however, there are additional factors you should consider as well. The conversion could put you into a higher tax bracket.

The taxable conversions could then increase your adjusted gross income (AGI), and possibly affect your ability to take certain credits or deductions.

The increased AGI could also impact you if you're collecting Social Security or are applying for financial aid for a college bound child.

State taxes (in addition to federal income tax) may apply to converted balances, so you would want to consult your tax advisor for help in determining your state's tax regulations.

You could decide to make smaller conversions over time to minimize any adverse impact to income and taxes. Conversion is not an all or nothing process.

You may have investment losses you have recently experienced that might result in a lower conversion tax bill when selling or journaling particular assets between accounts.

The yearly deadline for a conversion is December 31st but you generally have until October 15th of the following year to undo some or all of the conversion. This process is called a re-characterization, and you simply transfer the assets back into the traditional IRA. This also reverses the tax liability.

While not all encompassing, this should assist those that are considering a Roth conversion.

Thank you for the questions and topic suggestions – please keep them coming.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

Davis Investment Group custodies all client assets at Charles Schwab & Co. Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz