October 15, 2010

To Our Clients and Friends:

Capital markets for the 3rd Quarter of 2010 finished on a very strong note. The month of September was especially notable since the S&P 500 was up almost 9% in one month, bringing it back into positive territory for 2010 (up about 4% YTD). The strength in the equity markets is reflected in all our portfolios as they are now up between 5% to 7% for the year to date. **All of our portfolios are outperforming their benchmarks for the year and for longer time periods.** As we expect, our portfolios did not keep up with the market's upturn in September, but they are still well ahead on a yearly basis as they lost substantially less when markets were down in prior months. Our efforts to limit downside volatility have worked well so far this year and thus we have been able to add incremental gains which we then kept as the year has progressed.

As we head into the final quarter of the year we are positioned in a cautiously optimistic manner in all our portfolios. Our managers have been selectively adding names that they feel will add value by growing their cash flows over time. Most of the fundamental managers that we use prefer strong and growing operating cash flows over earnings because earnings measures can be much more easily manipulated through accounting adjustments than can cash flow measures. For example, a business owner might sell some goods to his customer on credit, he will account for the gain on the sale right away, however he will receive the actual cash only when the payment is made by the customer. If his customer is bankrupt then there is no cash flow and suddenly the gain is wiped out. This is a very simple example, but generally, over time companies that demonstrate an ability to consistently sustain and grow their operating cash flows are generally the ones that tend to trade at a premium to the market. Our managers are finding value in these types of companies because some of them are quite reasonably priced in the current environment and should provide a good risk adjusted return over a longer time period.

We would like to encourage you to visit our re-designed website www.rfgweb.com which should make navigation and accessibility much easier. Trevore has spent substantial time in the re-design and because of all his efforts the website now also has an additional feature, namely a blog which is titled “Soapbox”. We will continue to add informative articles and videos in our blog as a more immediate means of communication. We recommend that you tune into the “Soapbox” at periodic intervals to get our latest updates.

Year End Planning Considerations

To convert or not to convert, that is the question. Whether it is more profitable to pay the taxes now on the balance of an IRA and make it a Roth or to continue its growth and presume it won't be taxed into oblivion in the future. The Roth conversion question is one you should take up seriously prior to the end of 2010. If you want to do anything about it, prior to Thanksgiving! Here are our thoughts.

It now appears that most if not all taxpayers will be paying income taxes at the same rate in 2011, and perhaps even in 2012 that they are today. If this becomes true, (it is now our best guess based upon colleagues who watch this carefully) then one of the larger disadvantages to those with high incomes already may have been reduced. Here are our planning…

Rules Of Thumb (ROT) for Roth Conversions:

NO, if you are

Single with Taxable Income in Excess of $34,000 or
Married Filing Jointly with Taxable Income in excess of $68,000 and…
You don't yet have enough capital to retire;

Don't pass go, **don't convert,** stop worrying about it and increase your 401(k) deferral, start adding to deductible IRA's, or other savings and investment accounts. Save for your retirement, including reducing mortgage balances prior to saving for children's educations.

Yes convert, if all the above is true except;

You DO have enough capital to retire, in hand, after you pay the taxes on the IRA capital converted.

For example, your plan has been to leave your IRA/401(K)/TSA capital to your children, you don't need it. Convert. PS: There are likely more profitable ways to get this capital to your children or grandchildren.

Your income will be so low, even with the conversion that you will pay little or no taxes anyway.

For example a Single taxpayer with taxable income of less than $8,000 or Married Filing Jointly with taxable income below $17,000. Between these income levels you pay taxes at only 10%.

Please note that I use the acronym "ROT" on purpose for these kinds of generalizations, because they do not take your specific circumstances into account, and therefore cannot be considered by you to be specific advice from us. Please contact us if you need specific advice in this area, likely beginning with an analysis of the sufficiency of your existing retirement income assets.

Refinancing Existing Mortgages

Do consider refinancing at this time if you can get your mortgage interest rate into the 4.5% range and you are paying 5.5% or so or more. Fix the rate for fifteen or thirty years, unless you absolutely positively will be out of the home prior to the term of a shorter fixed period.

Plan to pay off your mortgage prior to your retirement, the opportunities to earn incomes on assets reliably in excess of the interest cost of a mortgage are slim, no mortgage in retirement is a GREAT emergency fund. Exception to paying off the mortgage: You have the free capital to pay off the mortgage, it is earning an after tax yield reliably and consistently in excess of your mortgage cost, AND the capital is liquid to allow you to repay the mortgage in full should this circumstance change. I am earning 5% tax deferred on the capital required to pay off my mortgage debt, and my mortgage interest rate is less than 1.75% (a very unusual mortgage, and no longer available) currently, so I am not yet paying off my mortgage debt.

Estate Taxes

It is absurd and irresponsible that our legislators have allowed the entire 10 year term of the last estate tax bill expire without implementing specific new estate tax legislation to replace it. Because of that, this year there is no federal estate tax on any size estate. There are capital gains taxes on larger estates because the "step-up in basis" previously allowed to ease the filing of estate tax returns is eliminated. This is cheaper for the few thousand estates in excess of $5 to $7 million each year, (Yay), but more complicated and costly for all estates due to the work and data required to file an estate tax return, (Boo). Until something is done, beginning January 1st of next year, a small $1 million dollar estate tax exemption will go into effect, with estate tax rates reaching 55%. Not much to do here. Expect a new law to pass that would exempt, $3.5 to $5 million of your estate from taxes, return the step-up in basis, and cap marginal rates on taxable estates to 35% to 45%.

In General

Do not let projections and too much speculation of future tax rates change what are good decisions THIS YEAR. Do not expect the math of a situation to lead you to the right answer, be sure to use logic in evaluating the risk assumed in any decision first, avoid the unacceptable risks, regardless of the math. That is usually the case, but is all the more so while such extraordinary tax, legislative, regulatory and economic uncertainty rule the day.

Please enjoy the beautiful weather we have been having, (for those of you in the Midwest anyway!) and the final quarter of the year. Expect the economy and markets to continue to improve, but slowly and without really signaling it much. Government has sufficiently hogtied and discredited itself that it likely cannot accomplish too much. THAT IS good economic news in and of itself.

Sincerely,

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