EMPIRICAL WEALTH MANAGEMENT®
Advice you can trust

Successful Investing

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What's New At Empirical

- We are proud to announce that the new Empirical website (www.empiricalfs.com) has been launched! In the coming months there will be new additions to the website. To be notified of these updates, please follow us on Twitter and Facebook. Be sure to check out the new calendar section to RSVP to events and seminars.
- To sign up for the Client View Portal or to receive ***paperless*** statements going forward, please email Simon Liu at techsupport@empiricalfs.com. For a visual overview of the Client View Portal, please go to **client.empiricalfs.com**.
- Follow us on Twitter and Facebook for the latest news, developments and research.
- Tune into Empirical Investing Radio every Thursday at 2PM PST on the VoiceAmerica business channel: *business.voiceamerica.com*

this issue

looking ahead

Capital Market Expectation ♦

A Review of Market Efficiency ♦

"The avoidance of taxes is the only intellectual pursuit that still carries any reward."

- John Maynard Keynes

Tax Minimization

It is our advice and practice that we manage investments by addressing issues in order of their importance. We make this determination by understanding which areas of planning give us the greatest opportunity to influence a client's specific situation. Many professionals and individual investors fail to heed this advice and focus on issues that seem relevant yet have proven to be both uncontrollable and largely irrelevant to long-term success. An example is allowing short-term market movements and daily financial news to guide investment decision making. On this topic, one of Warren Buffet's mentors, Benjamin Graham, had the following to say:

> *"Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."*

It will be no surprise to our long term clients that we believe the three main factors relating to long term investment success are diversification, asset allocation and discipline. After these three activities, the next most significant opportunity to influence our clients' investment outcome is through tax minimization.

The 7 Levels of Tax-Efficiency

Conceptually, we all understand that the less you pay to taxes, the more money you'll have left for the purposes you intend. While this sounds simple, actually achieving this tax reduction in practice takes considerable time and effort. The reason for this is that being "tax-efficient" takes more than just selecting tax-efficient investments. To this end, your Empirical team has incorporated multiple levels of tax minimization strategies that can be divided into two primary categories: Portfolio and Planning related strategies. While both of these strategies will increase tax-efficiency, the maximum value is received when they work together in a coordinated manner. ***Figure 1*** (next page) illustrates Empirical's seven levels of tax-efficiency starting with the most important at the base of the pyramid. In this letter, we will elaborate on two of the more complex concepts: Roth Conversions and Asset Location.

Roth Conversion: Convert assets while in a lower tax bracket to avoid paying taxes at a higher tax bracket.

Asset Location: Place high growth assets in a tax-free Roth IRA and low growth assets in a tax-deferred Traditional IRA.

Roth Conversions

A Roth Conversion involves moving assets from a Traditional or Rollover IRA to a Roth IRA. At the time of conversion, income tax will be due on the amount converted (except for dollars previously contributed on an after-tax basis). For example, let's assume Jane Sample has $1,000,000 in an IRA account and she decides to move $10,000 to a Roth IRA. After the Conversion she will have $990,000 in her Traditional IRA and $10,000 in her Roth IRA. Jane will owe income tax on the $10,000 moved into her Roth IRA in the year of conversion.

Why would Jane choose to pay tax now rather than later? The reason has to do with the tax rate for which she pays on the distribution. Let's assume that Jane just retired on January 1st, and is 60 years old. For the first time in her adult life she is in a low tax bracket, as she is no longer working, has not started Social Security, and does not have to worry about Required Minimum Distributions (RMDs) until age 70½. Due to the fact that she expects to be in a higher tax bracket later (once

Figure 1: **Empirical's Seven Levels of Tax Efficiency**

For a full description of each level, please see The Appendix at the end of this letter.

Social Security starts and RMDs begin), this presents a perfect time to consider converting IRA assets to a Roth IRA. However, to determine if a Roth Conversion is the right choice, a few other conditions must also be considered. Most important among these is that Jane will not need IRA monies for current income early in retirement (meaning she has money in a non-IRA account, or pension income, to support herself until later in retirement). The tax benefits are enhanced if the tax owed from the conversion can be paid from a non-IRA account.

The core idea is to convert assets while in a lower tax bracket and avoid paying taxes at a higher tax rate later (after Social Security and IRA Required Minimum Distributions start). This will have the effect of lowering your overall lifetime tax.

Further, there are several rules that apply to Roth conversions that make them an extremely flexible tax planning tool:

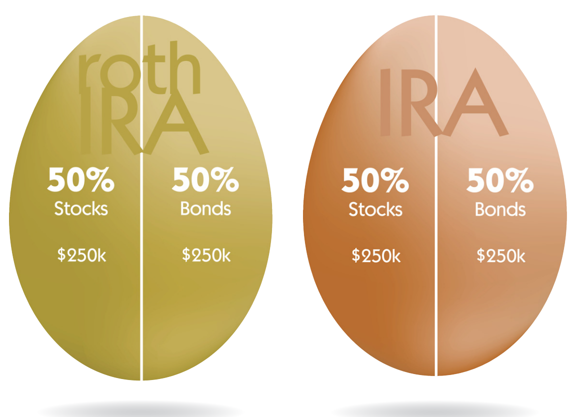
1. The amount of the Roth Conversion can be customized to fit your tax bracket (it does not have to be the entire IRA). Targeting a specific tax rate and converting only enough to reach that level is a common strategy.
2. Roth conversions can be "un-done" through what is called a recharacterization, which essentially moves the converted assets back into the IRA they came from, thus reversing taxation. This is helpful if the assets

Figure 2: **When Does It Make Sense To Do A Roth Conversion?**

converted to the Roth IRA drop in value (because income tax will be due on the value at the time of conversion).

3. A recharacterization must be done within the same tax year as the conversion to avoid filing an amended return.
4. The latest date to do a recharacterization is the extended tax filing deadline of the year after the initial conversion (typically October 15).
5. You can also "recharacterize and switch" if your spouse also has tax-deferred assets. In this scenario, if there is a market decline, one spouse's conversion is recharacterized and then a conversion is done with the other spouses IRA (who did not previously convert in the current year). This turns a drop in account value to your advantage by converting more shares while the market is lower. This is helpful since you have to wait the longer of the 30 days or the next calendar year before you can convert after you have done a recharacterization.

Figure 3: **Example of a $1mm Traditional Allocation**



Roth Conversions are often perceived to be undesirable because of our strong desire to avoid paying taxes today, even if taxes will be higher in the future and result in more tax over our lifetimes.

The Asset Location Decision

Asset Location and Roth Conversions go hand-in-hand. To see why, let's discuss each of the different types of investment accounts.

After-Tax Accounts (Individual, Joint, Family Trust): Capital gains, dividends and interest and qualified dividends are taxed in the year in which they occur. Short-term gains, dividends and interest are taxed as ordinary income, while long-term gains and qualified dividends are taxed at long-term capital gains rates.

Tax-Deferred Accounts (IRA, 401k, 403b): Money going into these accounts is usually tax-deferred and normally taxed as ordinary income when the money is withdrawn. Exceptions apply for dollars in which no deduction was taken after being contributed. You must also be over 59 ½ to avoid a 10% penalty.

Tax-Free Accounts (Roth IRA, Roth 401k): Money going into these accounts is after-tax, and is therefore not taxed when the money is withdrawn (subject to the five year rule). You must also be over 59 ½ to avoid a 10% penalty on any earnings.

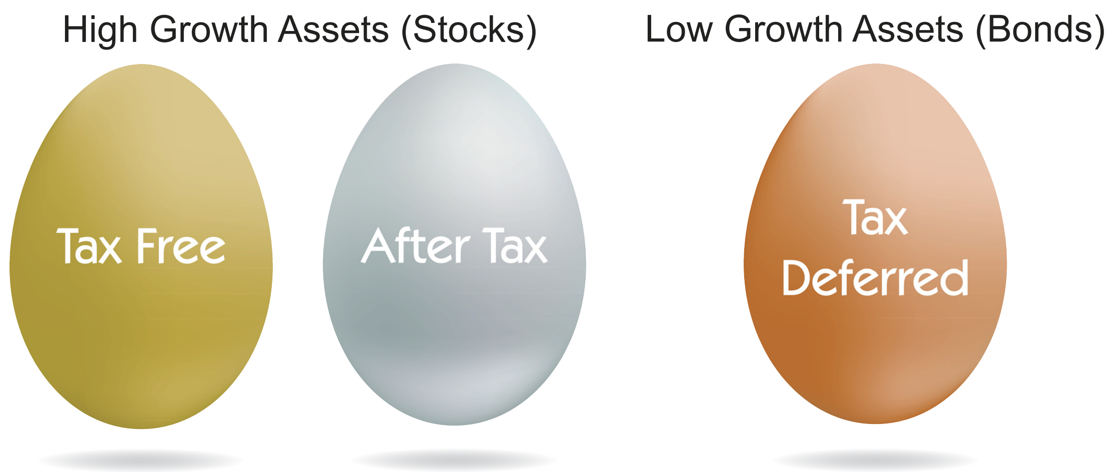
From this description of each type of account, we can see the value of choosing to hold the investments with the highest expected future return in the Roth IRA, as all future growth will be tax-free! What does this mean? Each year, as assets are converted from your Traditional IRA to your Roth IRA, you can choose which investments will be placed in the Roth IRA and which are used in the Traditional IRA. This allows you to hold more aggressive investments (like stocks) in your Roth IRA and hold more conservative investments (like bonds) in your Traditional IRA, while keeping your overall stock to bond allocation consistent. Over time, this strategy will help reduce future taxes by reducing Required Minimum Distributions, as more of the high growth assets will be in the tax and RMD-free Roth IRA.

Figure 4: **Example of $1mm Asset Placement Allocation**

Since ordinary income tax rates are usually higher than long-term capital gains tax rates, asset location is not only useful when considering Traditional IRA and Roth IRA accounts, but there can be benefits with this strategy when using after-tax accounts, as well. This is true since gains in after-tax accounts can be taxed at favorable long-term capital gains rates (currently 15%) as opposed to the normally higher ordinary income tax rates on money coming out of tax-deferred accounts.

As effective as this strategy is, there are a few rules that should never be broken, even in the pursuit of higher after-tax returns. Aside from maintaining a portfolio that is diversified across and within many asset classes, the asset allocation (mix of stocks and bonds) should continue to reflect each investor's willingness, ability and need to take risk. This means that each investor's personal *asset allocation*, whether it is 100% stocks, 100% bonds, or anything in between, should be maintained at all times. The *asset location* decision is layered on top of this to *fine-tune* an already sound investment

Figure 5: **What Does This Mean In Terms Of Your Portfolio Structure?**



strategy and allocation.

Given the benefits of Asset Location, should it always be used? The answer is not always. There are two scenarios when using asset placement can be especially dangerous. The first being when the account in question is used for income purposes. For example, a newly retired investor has $1 mm in total assets. There is $500k in a Traditional IRA and $500k in an after-tax account. The investor's *asset allocation* is 50% stocks and 50% bonds and he wants to use *asset location* because of the tax benefits. Let's also assume that the investor plans on taking regular withdrawals from the after-tax account before tapping into the tax-deferred account. In this case, it would be unwise to hold 100% of the stocks in the after-tax account and 100% of the bonds in the tax-deferred account simply because the account that is sustaining withdrawals would be far too volatile (risky). This could force our investor to sell stocks for income after experiencing a significant decline in portfolio value, which could severely reduce the longevity of the total portfolio.

Asset Location can also be dangerous to an investor's financial health if we focus more on the individual parts of a portfolio, rather than the portfolio as a whole. For example, an investor has a $1 mm portfolio with $500k in a Traditional IRA and $500k in a Roth IRA, and decides to implement an asset location strategy. Soon after this is implemented, stocks (held in the Roth IRA) drop by 10% while the bonds (held in the Traditional IRA) increase by 5%. In this case, when looking at the returns of each account side-by-side, the return difference will be very apparent, even though there is no difference in the return of the total portfolio (because the overall asset allocation is maintained when using asset location). This portfolio movement may cause the investor to feel regret, making it harder to stay on track with a prudent plan, or more seriously, prompt the investor to make a change (i.e. sell the investment which most recently performed poorly). These feelings are more likely to show themselves when large disparities in returns emerge, which can make it difficult to stay disciplined. Therefore, these strategies should only be used in situations where there is high confidence that the strategy and implications are well understood in advance.

Conclusion

Just as exercising only one muscle group will do little to improve your overall health; both Roth Conversions and Asset Location are advanced strategies that work best in concert with an overall tax minimization plan. Similarly, an overall tax-minimization plan works best when combined with prudent investment principals like diversification, asset allocation, and investment discipline, all of which require ongoing diligence to be effective.

If you are interested in seeing a full illustration of the concepts presented in this letter, please visit our website www.empiricalfs.com (**Go to Resources > Investor Education > Empirical Papers > Empirical's Retirement Advantage Program**). Roth Conversions and Asset Location are two of five topics discussed in this new presentation.

As always, if you should have any questions about these concepts please contact your Empirical advisor.

Sincerely,

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Principal | Chief Executive Officer

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Disclosure

There is always the risk that an investor may lose money. Even a long-term investment approach cannot guarantee a profit. Economic, political, and issuer-specific events will cause the value of securities, and the portfolios that own them, to rise or fall. Because the value of your investment in a portfolio will fluctuate, there is a risk that you will lose money. The information provided herein should not be construed as a recommendation to purchase or sell any particular security or an assurance that any particular security held in a portfolio will remain in the portfolio or that a previously held security will not be repurchased. It should not be assumed that any of the transactions discussed herein have been or will prove to be profitable or that future investment decisions will be profitable.

Appendix: Empirical's Seven Levels of Tax Efficiency

Investment Related Strategies

Level 1: Evidence-Based Investment Strategy

Overwhelming independent academic research concludes that the high turnover (frequent trading) of conventional investment management results in lower portfolio returns for individuals and professional managers. Therefore, Empirical focuses on a scientific portfolio structure designed to capture superior investment returns while requiring less trading.

Level 2: Tax-Efficient Investments

Investments with lower turnover have greater tax efficiency. On average, Empirical's recommended investments are more tax-efficient than 85 percent of traditional approaches.* Furthermore, when distributions do occur, a larger proportion are long-term (vs. short-term) in nature. This is important because short-term capital gains are taxed as ordinary income rather than the preferential long-term capital gains rates.

Level 3: Tax-Loss Harvesting

The only time we believe investors should deviate from a low turnover strategy is when the market presents the opportunity to engage in tax-loss harvesting and appropriate investment alternatives exist in the targeted asset class. Empirical actively looks to sell securities with losses as they occur, not just at the end of the year. These "booked" losses can be used to offset realized capital gains and mutual fund distributions as well as offset realized gains for non-portfolio related capital gains, such as real estate.

Planning Related Strategies

Level 4: Roth Coverage Analysis

In the right situation, engaging in Roth IRA Conversions can be a powerful tax management tool over an entire retirement horizon. Roth Conversion involves moving assets from a Traditional or Rollover IRA to a Roth IRA. Empirical will examine and customize recommendations to see if this highly effective and flexible planning tool makes sense for you.

Level 5: Asset Location

There are three primary types of investments accounts: after-tax, tax-deferred and tax-free. Each of these is preferred for different types of portfolio investments. Depending on individual client circumstances, Empirical may customize an asset location strategy for each client.

Level 6: Tax Return Reviews

Whether your tax return is being prepared by a tax professional or you are doing it yourself, by reviewing your tax return regularly, Empirical can help ensure that you are taking advantage of tax saving opportunities.

Level 7: Tax Return Preparation

Beginning with the 2011 tax season, Empirical started offering tax preparation services with the goal of enhancing efficiency and coordination between your investment advisor and your tax expert. We hope to expand this offering to include more complex returns in the future.

** Tax efficiency is estimated by comparing fund turnover of Empirical's selected investments versus Morningstar category averages.*