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MENTOR CAPITAL

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Mentor Monthly Missive

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Second-quarter results show improvement

Stocks bounced back during the second quarter this year, clawing back some of the losses they had experienced during the previous 17 months.

Although stocks still have a long way to go to return to their pre-October 2007 levels, we were encouraged that the world didn't end after all, as some had been predicting.

Investors who were hopeful that the worldwide economic downturn had reached a bottom bid up share prices beginning March 9, when the Dow Jones Industrial Average of 30 large stocks bottomed at 6547. On June 30 the 30-stock average closed at 8447, for a gain of about 29% for the period.

In contrast, shares of small-cap stocks, emerging-markets stocks and real estate funds topped the large-cap indexes during the recovery period. However, this was after a period during which these classes had fallen the hardest. Please see the accompanying chart.

Period returns ***Selected asset classes***	*Top to bottom* **10/11/07-3/9/2009**	*Bottom to 6/30/09* **3/9/2009 6/30/2009**	*Top to 6/30/09* **10/11/07-6/30/2009**
Emerging markets*	-82.13%	61.11%	-71.20%
Real estate*	-71.38%	43.43%	-58.95%
Small value*	-62.14%	55.13%	-41.28%
Foreign*	-61.97%	46.91%	-44.13%
Large value*	-60.59%	37.52%	-45.81%
Small growth*	-59.36%	51.85%	-38.29%
Large growth*	-51.22%	33.54%	-34.86%
S&P 500	-56.44%	35.89%	-40.84%
Dow Industrials	-53.29%	29.02%	-39.73%

No dividends reinvested

**Measured by the Vanguard exchange-traded fund tracking the class.*

What can we conclude from this admittedly small (and extreme) period of stock market returns? Pretty much what we already knew: Asset classes that are hit the hardest tend to recover the most quickly, and small-cap stocks, emerging markets stocks and real estate stocks tend to be the most volatile.

Investors who rebalanced during the downturn – sold bonds, which had held their own, relatively speaking, and bought stocks – benefitted the most from the subsequent upturn.

Going forward, we continue to believe that markets – both stock and bond – will revert to their mean returns over time.

Special deal from Uncle Sam – Good or not?

A lot of high-income individuals are excited about a special deal the federal government is offering next year that will allow unlimited conversion of regular IRAs to Roth IRAs.

In its usual "spend now and worry about the future later" approach, in 2010 Uncle Sam is lifting the income limitation (currently $100,000) on Roth IRA conversions. This means that even people making $1 million a year can convert their regular IRAs to Roth IRAs. The special deal will allow converters to pay half the taxes due in 2011, the other half in 2012.

The result is likely to be a big increase in federal revenues in 2011 and 2012 following the rush by high-income taxpayers to convert their IRAs next year. But it's also going to mean lower federal revenues in future years when those who otherwise would be taking taxable distributions from their regular IRAs take non-taxable ones instead from their Roths.

There is a lot more than simply the beauty of a Roth IRA that needs to be considered by the owner of a regular IRA – high income or otherwise – who is considering such a move.

First, do you have the funds to pay taxes on such a conversion? A $100,000 conversion for someone in the 35% tax bracket will cost $17,500 in 2011 and $17,500 in 2012. If you have to pay the taxes due with tax-deferred assets, converting is probably not a good idea.

Then there are the variables, each of which has an influence on whether conversion makes financial sense: Current tax bracket, tax bracket when distributing, rate of return during accumulation, rate of return during distribution, number of years during accumulation and number of years during distribution.

Low current tax bracket, high future tax bracket, high investment returns and long accumulation and distribution periods all make conversion a financially sound decision.

But because all these variables except current tax bracket are unknown, there is a risk that a high-income, high-bracket individual converting in 2010 will have made a bad financial decision. High current tax bracket, low future tax bracket, low investment returns and short accumulation and distribution periods all will work against an individual making a conversion.

Mentor Capital has a system that can help in the decision-making process. If you are interested in converting regular IRA assets to Roth IRA assets, call one of our advisory team members to talk.

Tax increase, anyone?

June 2009 was a historic month: It was the first time the federal budget deficit exceeded $1 trillion.

To put this in perspective, it means that during the previous 12 months the government spent $3,274 more than it took in for every man, woman and child in the U.S.

How will this shortfall be covered? The Treasury will simply issue more debt. We – and our children and grandchildren – will have to service that debt, in the form of higher taxes in the future.

We're concerned that President Obama and the Congress are focusing on the wrong part of the revenue-generation equation: increasing taxes. This is likely to slow economic growth. We'd be happier if we saw at least some effort aimed at lowering taxes, especially on small businesses, which would boost employment and stimulate the economy.