If you are having trouble reading this email, read the online version.
Please do not reply to this email

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

May 29, 2009

The Roth IRA Edge

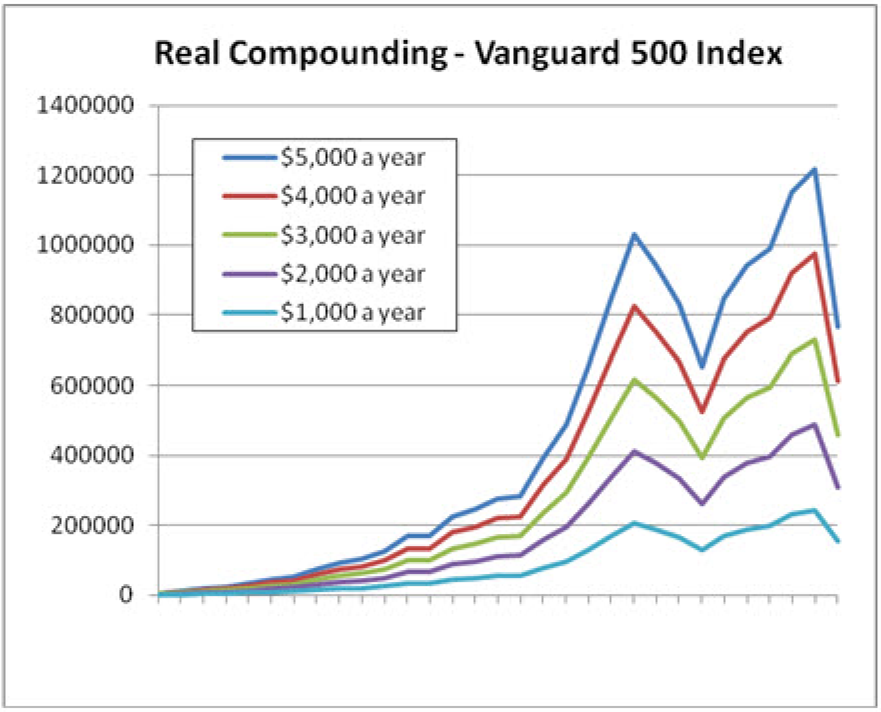
In our last *Adviser Fund Update,* we discussed some common mistakes to avoid when investing for retirement. This time around, we thought we'd talk about one of the very best retirement savings vehicles currently available to the American investor, the Roth IRA. This type of account is a fantastic means by which to invest savings for retirement, and the special features, most notably tax-free withdrawals and the lack of compulsory distributions, gives the Roth IRA a huge leg up on traditional IRAs and other types of retirement savings accounts.

With a key rule change taking effect next year, we thought this would be a good opportunity to give you a rundown on how Roth and traditional IRAs stack up, and then next time, we'll have a story for you on the new rules and how you can take advantage of them.

So, let's lay the groundwork for why tax-deferred and tax-free savings accounts, and the Roth IRA in particular, are a spectacular way to fund your retirement.

The Power of Compounding

You don't have to invest in a retirement savings account to benefit from the mathematics of compounding (the act of generating earnings from previous earnings), but the mechanics truly shine in a tax-free or tax-deferred account. Just how powerful is compounding when combined with regular additional investments? Take a look at the chart below to see what would have happened had you made various annual contributions to Vanguard's 500 Index over the last 30 years.



As you can see, even with the precipitous drop off in 2008, by investing a modest amount at regular intervals over a long period of time, you can amass truly impressive savings. For example, an initial $5,000 investment plus 29 subsequent $5,000 annual contributions ($150,000 invested total) yielded an end value of $767,363, more than four times the amount invested. The investor that put away $1,000 per year (a total of $30,000 invested) ended up with $153,473. That's pretty good, especially considering that these scenarios were matched to a broad market index rather than a well-diversified portfolio, such as the ones we've designed for our clients.

IRA Basics

So now that we've looked at how compounding and regular contributions can work for you, let's review some IRA options. There are two main types of IRAs (short for "individual retirement arrangement"): Traditional and the aforementioned Roth, both of which have the same annual contribution limits (for tax year 2009 the limits are $5,000; $6,000 for those over 50).

With a traditional IRA, contributions are tax deductible and all gains compound tax-free until you make withdrawals, at which point you will be subject to income taxes on what you take out (you will also be assessed a 10% penalty on any withdrawals made before age 59½).

One catch with a traditional IRA is required minimum distributions (RMDs) once you hit age 70½—at that point you are obligated to withdraw a certain amount of your IRA's assets each year or face penalties. (RMDs are mandated by the IRS, which provides several tables—the most common being the "Uniform Lifetime Table"—to help taxpayers calculate what they need to withdraw each tax year. For tax year 2008, for example, an 80-year-old retiree with a $100,000 IRA was given a "distribution period" of 18.7 years to fully draw down her IRA. So to calculate her distribution, she would have divided her account value by 18.7 to come up with her RMD of $5,348. Note that the RMD rule has been temporarily lifted in 2009 as part of the government's efforts to grant relief to taxpayers.)

Traditional IRAs are also less friendly to investors over certain income thresholds who are also covered by an employer-sponsored retirement plan. In tax-year 2009, if you contribute to say, a 401(k) plan and make more than $55,000 as a single tax filer (or a combined $89,000 for married couples filing jointly) your tax deduction for contributions to an IRA begins to be limited—if you make more than $65,000 ($109,000 for married couples), your contribution becomes nondeductible. That doesn't mean you can't contribute to an IRA. In fact, many people do. You just can't deduct your contributions when you make them (though you will be able to deduct those after-tax contributions from further taxation when you make withdrawals down the road).

The Roth IRA differs in a number of ways, the first being that contributions are made after-tax. Plus, those after-tax contributions can be withdrawn tax-free at any point (meaning, if you put $3,000 in one year and find you need to spend that $3,000 the next year, you can withdraw it without taxes or penalties), rollovers and conversions can be withdrawn tax and penalty-free after a five-year "seasoning" period regardless of age, and there are a number of special circumstances (such as severe disability, high medical expenses or a first-time home purchase) in which distributions can be taken penalty-free. There are also no RMDs—you can continue to grow your account for as long as you want. For this reason, Roth IRAs are a good way to save money tax-free to leave to your heirs, who will never have to pay income tax on the inherited account, although they will be required to take distributions over their lifetime (Note: all IRA types are subject to estate taxes). Otherwise, like a traditional IRA, you are subject to income taxes and the 10% penalty on withdrawals of any gains or income before age 59½ (or if you violate the five-year seasoning rule). After that, all distributions are tax-free.

The big downside, however, has always been the Roth's limited accessibility. Investors who make over $105,000 a year as a single tax filer (or are married, filing jointly, with a combined income over $166,000), are limited in how much they can contribute to a Roth IRA. If you make over $120,000 a year as a single tax filer ($176,000 for those married, filing jointly), you can’t contribute to a Roth IRA at all (these income limits are for tax-year 2009 and increase from year to year, based on inflation). And if you make over $100,000 (whether you are single or married) you are prohibited from converting a traditional IRA into a Roth IRA.

	IRA Attributes	
	Roth IRA	**Traditional IRA**
2009 Contribution Limits	$5,000 a year ($6,000 if over age 50)	$5,000 a year ($6,000 if over age 50)
Taxes	Contributions made after-tax; No taxes on distributions	Contributions made pre-tax (deductible from income taxes); Distributions taxed at income tax rate
Income Restrictions	Cannot contribute if you make over $120,000 as a single tax filer or $176,000 for married couples filing jointly; Can't convert/rollover into Roth IRA if income is over $100,000 (single or combined)	If participating in an employer-sponsored retirement savings plan contributions become nondeductible if you make over $65,000 as a single tax filer or $109,000 for married couples filing jointly; Otherwise there are no income restrictions
Required Minimum Distributions	None	At age 70.5 you must begin taking distributions based on life expectancy to avoid losing 50% of the required annual distribution amount in penalties
Penalties	10% on distributions that violate the 5-year seasoning rule; Income taxes and a 10% penalty on distributions from gains made before age 59.5	10% on distributions made before age 59.5

So the basic advantages and disadvantages of these two types of investments are pretty clear cut (see table above)—traditional IRAs give you an immediate tax break when you contribute and allow tax-free compounding until it's time to begin taking withdrawals (at which point you pay whatever your future income tax rate will be on them), while penalizing you for any withdrawals made before age 59½, and eventually require you to begin taking money out, whether you want to or not. Roth IRAs give no initial tax benefit, but offer you more penalty-free access to your savings, and when (and if) you do choose to begin making withdrawals after age 59½, all distributions are tax-free (so long as they don't violate the five-year seasoning rule). This makes Roth IRAs a particularly potent way to save money for retirement—far superior to a traditional IRA—as the table below shows.

30 Years of IRA Earnings and Taxes

	Roth IRA	Traditional IRA
Sum of contributions	$150,000	$150,000
Account Value After 30 Years	$767,363	$767,363
Taxes paid on contributions	$58,333	-
Tax savings on contributions	-	$42,000
Taxes paid upon withdrawal	-	$214,862
End value after taxes paid/saved	$767,363	$594,501

Note: Assumes $5,000 a year invested in Vanguard 500 Index from 1979 through 2008, taxed in the 28% bracket and no penalties on withdrawals

Using one of the same scenarios charted up above—the gains on $5,000 a year invested in 500 Index over the last 30 years—we've calculated the taxes one would pay in the 28% bracket (the highest bracket one could nominally fall into and be under the income limit to be eligible to invest in a Roth IRA) in both types of IRAs. While contributions to a Roth IRA are made after-tax, to get that $5,000 after-tax investment, you would have to earn $6,944 pretax, and thus pay $1,944 in taxes—over 30 years, that adds up to a total of $58,333 in taxes paid on contributions. In contrast, a traditional IRA investor would have saved $42,000 in taxes on their pretax contributions to their account ($1,400 a year). However, if that investor withdrew all of their earnings at once, they would owe nearly $215,000 in taxes. Let's just imagine that investor had stuffed the $42,000 saved on taxes over the years under the mattress for a rainy day—that sum added to the total in her IRA minus taxes due would leave $594,501 to spend in retirement. The Roth investor would get the entire $767,363 tax-free, and would have paid nearly $157,000 less in taxes while saving it.

But let's get back to that $42,000 the traditional IRA investor saved in taxes over the years for a minute—what if instead of tucking it away, the investor did the smart thing and invested it in a taxable account each year? Couldn't the gains in that account be used to offset the taxes due on the IRA? The answer is yes, but only partially. Say the traditional IRA investor took the $1,400 a year in tax savings and also invested it in 500 Index over the same period. Before taxes, that account would exactly match the nearly $215,000 in taxes owed in the 28% tax bracket on the IRA. However, if that account was sold for cash, the investor would owe $25,929 in capital gains taxes (taxed at a 15% rate), leaving her with $188,932 (note that this figure does not account for the taxes that would have been generated along the way by distributions) and a total combined tax bill on the IRA and the taxable account of $240,791. If we add up the total of the two accounts after taxes, the traditional IRA investor who invested her tax savings along the way would end up with $715,505 after taxes, over $52,000 less than what the Roth IRA investor accumulated.

We hope by now the Roth IRA edge is clear. So long as you are making steady contributions and you'll be in the same or a higher tax bracket in retirement, a Roth IRA will net you more savings for retirement and many fewer tax headaches than a traditional IRA along the way, all other things such as your tax bracket in retirement, being equal.

Keep a look out for our next *Adviser Fund Update* two weeks hence, when we'll have more on the upcoming Roth IRA conversion rule change and how to prepare for it.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and $850 million dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.

Adviser Investments
85 Wells Avenue
Newton, MA 02459
USA