



FERGUSON ASSET MANAGEMENT, INC.

Investment Counseling & Asset Management for Individuals & Institutions

Year Beginning Report and Commentary

January 2010

Last year when I started the year beginning commentary for 2009 (There was a pre-inauguration and then a second, post inauguration report) I said, “We know that 2008 was the third worst year for our domestic stock market in the past 108 years. There is much doom and gloom but also some unbridled optimism in the investment world.”

Optimism won out!

This commentary looks at reasons why we should maintain that optimism but with a dose of pessimism. Just like in the cowboy westerns of yesteryear we appear to be gaining on the bad guys. But, are we in the clear, what’s over the ridge, and, God forbid, are we headed into a box canyon?

Stay tuned, this is only the first of several commentaries this script writer will make in 2010.

Just like the Epstein twins who wrote the screenplay to one of the greatest movies of all time, *Casablanca*, we don’t know what ending will be used.

TO ROTH or NOT to ROTH that is a serious, and not always easily answered, question. *A Roth conversion is not for everyone because the conversion amount is considered ordinary income and added to your income, for tax purpose, for 2010.**

Prior to 2010 not everyone was eligible to convert retirement accounts to a Roth IRA. Now, for one year only, 2010, we can all convert to a Roth.

Non Roth retirement account (regular IRA’s, 401k, 403b, T.S.P, rollovers, etc) distributions or withdrawals are taxable and show up on your tax return as ordinary income. Roth accounts grow tax free and the distributions are also tax free.

Both Roth and non Roth retirement plans are also included in your estate and, depending on the size of your estate (over \$3.5million) includable in calculating your estate taxes. [Horror story... Your taxable estate is \$5million and \$1.5million is in non Roth retirement accounts.

House and illiquid business are worth \$2M of the total. Tax on the estate is 45% of excess over \$3.5M or 45% of \$1.5M which is \$675,000. The estate sells the retirement account to pay for the estate taxes and because of the sale incurs an income tax of 30% on the \$1.5 liquidation. The tax due amount is \$450,000. Add the tax payments of \$450K and the \$675K and the value of the 1.5 million dollar retirement account is now worth only \$375,000.]

[Worse, even still, is if the beneficiaries sell an appreciated house and a business with a low basis. Without proper planning the 5 million dollars that Mom and Dad were worth could easily end up at about half that going to the heirs] No wonder some of us believe the estate tax should be abolished. But, I digressed.

* The income tax due may be paid ½ in 2011 and ½ in 2012

We have a Roth analysis program that we are using to evaluate the pros and cons of client conversions. Several items clearly stand out.

Don't pay the income taxes that the conversion triggers from your retirement account fund. Almost always it isn't worth it because you dilute the amount that can grow tax free. The taxes due (in 2011 and 2012) should be paid from your non retirement assets such as your personal or joint accounts. If most of your investment assets are in retirement accounts and you are over fifty, a conversion is a very iffy proposition. (We actually assess each client on a one on one basis)

If you are under fifty conversion is almost always a go. If you are over seventy and your estate may not owe estate taxes you are very iffy. If you and your spouse are over 65 and have no family or friend beneficiaries conversion is also questionable. Each situation is different. Also, the percent that should be converted varies.

Another meaningful event to ponder is changes to future tax rates. Say you are paying the near maximum federal income tax rate of 35% and conversion analysis indicates that it is not to your advantage to move to a Roth. If federal tax rates were to move higher in the future and you would then be in a 45% tax bracket conversion would have been very much to your advantage.

Some examples:

Age	83	83	72	40
Age at Withdrawl	83	83	72	67
Withdrawals to last	20 years	10 years	12 years	26 years
Amount converted	\$700K	\$500K	\$300K	\$200K
Taxes paid from the retirement account	Yes	No	No	No
Estimated conversion	-\$40,000	+\$877	+\$5,500	+\$135,000

Benefit				
All tax brackets at 35% and all investments are balanced portfolios in this example. This illustration may cause you much confusion. Good! This is not a no brainier process.				

As you can see each conversion must be weighed on a number of factors. Your same age sibling may find that converting a portion of their retirement funds is to their advantage while your situation may dictate an entirely different outcome.

Finally, on this subject, conversion may be done anytime during the calendar year 2010. We will continue working on your conversion analysis during this first quarter.

Optimism and an Economics 101 lesson?

According to the index of *leading* economic indicators the domestic economy is on course for a commanding recovery. The index rose 1.1% in December from November. This was the indicators ninth straight monthly gain. The *leading* economic and financial indicators include: building permits, interest rates, consumer confidence, business outlook survey, money supply, and consumer durable goods orders.

From my perspective these indicators, most of which are based on data one or two months old, merely indicate the direction we are headed at this moment. According to Paul Samuelson, winner of the Nobel Prize in economics, the leading indicators have allowed economists to predict nine of the last five recessions. [Not a misprint]

Take this current positive economic indicator news with a smile and a cup of coffee.

The *lagging* economic indicators change after the general economic recovery has occurred. Understanding which ones are lagging may allow you to better assess the nightly news. Often you will realize that the commentator hasn't a clue about what they are talking about or what it really means. We already know unemployment is bad but it isn't a leading indicator.

We should see no real meaningful improvement in this lagging data such as unemployment rate, business spending, unit labor costs, bank loans outstanding, bank interest rates, and book value of trade and inventories until after the general economic recovery has occurred.

Take this sad lagging state of affairs for our unemployed with two aspirin and a prayer.

We believe the future economic recovery from the overly stimulated government stimulus remains uncertain. We don't see a booming V shaped recovery across the country but a longer drawn out U shape taking place. We'd be pleased to see high single digit annualized domestic stock market returns over the next 3-5 years.

Interest rates are in a confused state as it appears from the administrations, bank bashing, and credit tightening comments of January 21st. I too want to reign in banking's unethical, go for

broke trading practices. But to tighten lending with 10% unemployment indicates to me that most elected folks in Washington don't have a clue what happens in the real world of banking and finance. Fortunately I spent some time on Wall Street, in the Chicago commodity markets, and early in my career doing grunt type basic market research.

When I was in college I worked for Cornelius Vanderbilt "Sonny" Whitney. I thought I wanted to be a race horse trainer and worked as a groom cleaning the horses and stalls. Mr. Whitney said, "You can't train my horses if you haven't learned how to shovel the s____."

Very few of our elected officials, it would appear, have ever held a business shovel. Of course, why not, their business is the business of being reelected. I am not anti-government but a frustrated former precinct captain.

History and an Allocation Update

You have probably heard or read about the negative performance of the "market" (see Russell 1000 returns in the following chart) during the past ten years. I have read two articles that reveal and highlight this negative return. Both articles announce that if you had stayed away from stocks and put your money in Treasuries you would have had positive returns. This type of reporting we call journalistic porn.

The facts on returns from July 1999 through June 2009.

Category *	10 year annualized return	
Russell 1000	-1.75%	(The above mentioned "market")
Large Cap Value	1%	
Small Cap	4.66%	
US Micro Cap	5.84%	
US Small Value	6.32%	
World ex USA Index	1.63%	
Int'l Large Cap Value	5.31%	
Int'l Small Cap	7.02%	
Emerging Mkts Value	12.36%	

- The category examples are all Dimensional engineered index Funds except the World ex USA Index.

- The Dimensional Funds outperformed their category index, i.e. Russell or MSCI indices, in all categories during the ten year period.

We subscribe to the belief, based on overwhelming historical data, that asset class allocation, not stock picking, is the key to portfolio and wealth management. We use over twenty asset classes including those mentioned about plus others that include real estate, total commodity funds, fixed income, and on occasion, with client approval, private placements.

We base each client's allocation on your goals, objectives and tolerance for risk and we continually monitor the allocation and performance of your portfolios.

Rates

Interest rates are still near historic lows. Five year US Government Bonds are yielding 2.42%, five year Muni Bonds are 1.63%, Prime is 3.25%, one year insured CDs are 0.50% and ten year A rated corporate bonds around a 4.5% yield. We believe rates may well trend higher during 2010-2012.

Enjoy the remainder of this unusual winter weather pattern.

A copy of our most recent ADV filing, with the SEC, is available to you upon request.