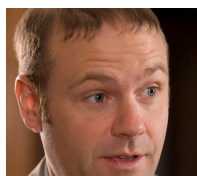


Parsec Financial

FOURTH QUARTER 2009 NEWSLETTER

The Year of the Roth, the Income Tax-Free IRA



Rick Manske, CFP®

MANAGING PARTNER

INSIDE THIS ISSUE:

| | |
|--|---|
| Roth Conversions | 1 |
| Economic Commentary | 2 |
| 2009 Stock Market: Year in Review | 5 |
| An Unusual Stock Market | 6 |
| Schwab Statements are Changing in January | 8 |

SPECIAL POINTS OF INTEREST

- The 2009 stock market rebound was one of the sharpest rallies in history.
- Total donations from the firm and employees was over \$115,000 in 2009.
- Cost basis information is being added to Schwab's statements.

New rules regarding Roth IRA conversions stand to make Roth IRAs the most written about financial planning topic for the year 2010. There are a myriad of rules and technicalities associated with IRAs, Roth IRAs and conversion from IRA to Roth IRA. As a result of the many potential scenarios and ambiguities, each financial planning scenario has to be individually considered before a recommendation can be made. However, there are a few rules of thumb that can help to determine if a conversion to a Roth IRA is an appropriate strategy to embark upon for some or all of your retirement portfolio assets. Generally we feel most investors should strongly consider the use of a Roth IRA.

1. When an IRA is converted to a Roth, there are federal and state taxes owed on the taxable portion of the conversion. The Roth IRA then enjoys tax-free earnings, tax-free withdrawals and no required minimum distributions.
2. Any non-deductible contributions that have been made to your IRAs can be considered return of basis for your conversion and therefore be non-taxable. If you convert less than the total of all of your IRAs combined, the converted amount is considered to have a pro-rata portion of the basis of all of your IRAs combined.
3. The ability to convert a traditional IRA in 2010 is open to everyone regardless of income. These 2010 conversions have the added advantage of the resulting taxable income being spread evenly over tax years 2011 and 2012. Conversions beyond 2010 will be taxed in the year of conversion.
4. Not just IRAs are eligible. Former work sponsored retirement plans, SEPs and SIMPLE plans are also eligible account types to consider.
5. Under most scenarios you should only convert if you are able to pay the associated tax liability from a non-qualified, after-tax account instead of the IRA being converted. If you pay the conversion tax by withholding taxes from your IRA and you are younger than age 59.5, an early withdrawal penalty will be assessed. Also, paying the tax from the conversion proceeds lowers the available balance to grow tax-free in the Roth IRA.
6. Many client scenarios would benefit from a conversion of a portion of the IRA. This allows you to control the cost to convert by keeping your income in the desired range according to your unique year-end tax plan. Taxable conversion amounts can bring you to a higher income tax bracket, or affect the amount of tax you pay on your social security benefits and your Medicare premium. Future tax rates are uncertain. As a result, a partial conversion is oftentimes the best advice, allowing you to diversify your retirement portfolio between account types with various potential benefits.

7. Roth IRAs do not have required minimum distributions and as such, enjoy a longer preferential tax treatment than a traditional IRA that has required distributions at age 70.5. Furthermore, Roth IRAs are wonderful accounts to inherit and can benefit your beneficiaries who can withdraw the money, income tax-free, over their lifetimes.
8. If converting you can still contribute to Roth and Regular IRAs, contribution rules apply. You are eligible to convert even if taking a required minimum distribution. If necessary, Roth IRA conversions can be reversed through a process called recharacterization.
9. There are several important dates associated with Roth IRAs. The decision to convert needs to be made by December 31 of the year you plan to convert; decisions to

“recharacterize” must be made by October 15 of the year following conversion.

10. If your estate is taxable, the payment of income taxes will lower the estate and thus, the estate tax. Therefore, a Roth IRA conversion can lower the estate tax by “pre-paying” the income taxes associated with retirement accounts.

We are here to assist you with your decision as to whether you should convert, and if so, how much. However, it is important to begin to identify resources that you would use to pay for a conversion and gather the requisite information underlying your unique scenario - taxable income, total IRAs, basis in IRA, etc. Consult with a qualified tax advisor for further information.

Dr. Jim Smith's Economic Commentary



Dr. James F. Smith

CHIEF ECONOMIST

The U.S. Economy Is Growing Again

The latest (November 24) data from the Bureau of Economic Analysis (BEA, website: bea.gov) of the U.S. Department of Commerce show that real GDP grew at a seasonally adjusted annual rate of 2.8 percent in the third quarter. That was much lower than the original estimate of 3.5 percent, but is the first positive report since the third quarter of 2008. Since the advent of quarterly data in 1947, we have never before experienced four consecutive quarters of decline in real GDP.

Every economic forecaster expects not only that the fourth quarter will grow too, but also that all of 2010 will see decent economic advances as well. Some people worry about 2011, not least because that is when all of the tax cuts of 2001 and 2003 will expire under current law, but that seems a long way off right now.

On December 4, the Bureau of Labor Statistics gave us what was by far the least negative employment report since the last positive one in December 2007. The total number of non-farm payroll jobs on a seasonally adjusted basis declined “only” 11,000 in November from October. Since the standard error of these data is 107,000 that means that there is a

95 percent probability that the “true” number was between an increase of 96,000 such jobs and a decline of 118,000. Furthermore, the data for September and October were revised and now show much smaller job losses than previously reported. The upward revisions were 80,000 nonfarm payroll jobs in September and 159,000 in October. The revised job losses are 139,000 in September and 111,000 for October.

That means there is considerable momentum in the economy that is not being picked up in the first reports on employment. That is usually a sign that economic growth is accelerating more rapidly than most analysts expect.

We are also seeing good news on retail sales, a very important economic indicator as personal consumption expenditures (PCE) make up around 70.0 percent of GDP and retail sales are about half of PCE. We would probably get even stronger reports but retailers have been extremely cautious about adding inventory to satisfy demand.

This is not terribly shocking as last year was the first time in over fifty years that retail sales in the Christmas holiday season declined from the year before. It would take a very strong conviction (and a rare good line of credit) for a retailer to gamble on a big increase in inventory this year.

Unfortunately for retailers, it's far easier to make a sale from goods in stock than from promises of goods coming in the future. It's even harder to convince a person looking for that really unique gift for that important special person

that a gift certificate will work just as well.

The official forecast of the National Retail Federation is that retail sales in November and December will be 1.0 percent less than in the same two months of 2008. If that came true, it would be the first time since the dark days of World War II that such an event had been observed. That was only because most civilian production of durable goods (appliances, cars, furniture, and so on) had been converted to the effort to defeat the Axis powers—Germany, Italy and Japan.

My expectation is that we'll see a decent increase in the 1.0- to 2.0 percent range. That's not spectacular, but given that prices are about the same as last year or lower and that inventories are lean, it would be a pretty good outcome.

To really get the U.S. economy moving at a good pace (3.1 percent or more, the 120-year annual average real GDP growth rate) requires two things. The first is for monthly growth in nonfarm payroll jobs to get back to the 250,000-300,000 range. The trend of the last six months, if continued, suggests we should be there by March or April of 2010.

Such job growth would support good income growth and would undoubtedly lead to significant increases in consumer sentiment. That's a nearly foolproof prescription for big rises in retail sales. When retail sales rise, employment grows more, incomes grow more, industrial production increases and real GDP hits new records. That's exactly the scenario we all want to see.

One action that President Obama could and should take to ensure strong global growth is to put a big effort into getting the Doha Round of the World Trade Organization (WTO) completed as soon as possible in 2010. He has already succeeded in getting the members of the G-20 in Pittsburgh in September, who collectively represented about 85 percent of global GDP, to agree to finish this long-delayed effort (it began with the Fourth Ministerial Declaration from Doha, Qatar in November 2001) to significantly increase world trade.

The World Bank has estimated that completion of this effort would add over \$2.0 trillion to global economic output every year forever. No other economic action that governments could take would do more to improve the world economic environment.

Nearly all (at least 95 percent) of professional economists support the idea of free trade. The basic case was laid down in 1776 in that masterful treatise, *The Wealth of Nations*, writ-

ten by Adam Smith, who was a professor of moral philosophy at the University of Glasgow in Scotland. It was improved by David Ricardo, another famous British economist and member of Parliament in the early 1800s.

The idea is that any country should focus on producing those goods and services in which they have a comparative advantage (an absolute advantage is not necessary). What that means is that a country (or a state, city or individual for that matter) should concentrate on the things they do best and sell that output to other countries and use the proceeds to buy goods and services in which they do not have a comparative advantage.

This means that businesses and consumers in a country can buy the largest possible amount of goods and services at the lowest cost. That means they can produce more and increase wealth.

All of this seems so simple and obvious and is so well documented in over 200 years of analyses and studies that it is very difficult to see why there are any politicians who don't understand these very basic principles for wealth creation. Every president from Franklin D. Roosevelt to Barack Obama has seemed to get it. However, trying to get agreements to lessen restrictions on trade through the U.S. Congress has always proven difficult.

At the moment, Congress is being obstructive on trade agreements that have been negotiated with Colombia, Panama and South Korea. The sooner they approve them, the sooner the U.S. economy will start getting positive impacts from increases in exports to those countries.

The second thing that needs to happen to get U.S. economic growth back to its long-term average is to see a stabilization in house prices. The overwhelming majority of households in the U.S. own a home (67.4 percent on a seasonally adjusted basis in both the second and third quarters of 2009 according to an October 29 Census Bureau report) and they would obviously feel a lot more confident if they were convinced the value of their home was stable or growing again as was the long-run trend from 1946 to 2007.

There are some hopeful signs in this regard. The Federal Housing Finance Agency reported on November 27 that its price index for all housing transactions in the U.S. in the third quarter of 2009 (both for buying a house and for refinancing one) was down 4.1 percent from the same period in 2008.

That's not positive, of course, but it is a smaller decline than we had been seeing. In addition, they reported that the "purchase only" price index had risen by 0.2 percent from the second quarter.

The Case-Shiller house price indices, which cover 20 metropolitan areas, have risen for five months. Still, their September number (reported on November 24) was 9.4 percent below a year earlier, even with those five months of rising prices.

Average home prices are still only at their level in June 2003. That means that on average people who bought a house after that date own an asset that is worth less than they paid for it. That is not true for the Asheville MSA, by the way.

All analysts agree that a major factor driving up demand for houses in 2009 was the tax credit of up to \$8,000 for people who bought a house if they had not owned one for three years or more. That was supposed to expire in November, but Congress extended it to cover any house for which a contract was signed by May 1, 2010 and closed by July 30.

Congress also added a tax credit of up to \$6,500 for people who own a house and have lived in it for at least five of the last eight years. Both of these programs are expected to provide quite a boost to housing activity in the first five months of 2010.

The impact of the original tax credit was clear in the report on third quarter real GDP. New investment in residential construction added 0.45 percentage points to the total 2.8 percent real GDP growth at a seasonally adjusted annual rate in the third quarter. That was the first positive contribution to real GDP growth from residential construction since the fourth quarter of 2005.

It's particularly useful for residential construction to return as a contributor to growth now because nonresidential construction is a lagging indicator that had been adding to growth until the third quarter of 2008. It has been reducing

real GDP growth since the fourth quarter of 2008 and that is expected to continue for at least another year and probably two or even three more years. There is a huge and growing amount of excess capacity in every category of commercial real estate. That means it will take a long time to absorb it and to get enough demand from commercial clients to generate new construction.

It is quite likely that Congress will extend the tax credits for housing to last for all of 2010 before their scheduled expiration next year. It won't escape their notice that 2010 is an election year. It is also likely that a very large number of incumbents will have a very difficult time getting reelected in 2010.

In the last 80 years, every president except Franklin D. Roosevelt and George W. Bush has seen his party lose seats in Congress in their first midterm election. There were so many Democrats who were elected in normally Republican districts in 2008 that it would be absolutely shocking if they don't lose 20 or more seats in the House in 2010.

The economic outlook is pretty good. The consensus among the 48 participants in the National Association for Business Economics forecasting panel is for 2.9 percent growth in real GDP in 2010. My forecast is 3.2 percent, so it's not far above the average. The top five panelists have growth above 4.0 percent and the bottom five have it below 1.0 percent.

That's quite a spread. It will be quite interesting to see how 2010 unfolds and especially if other major countries such as Germany and Japan return to growth. Europe and Japan have seen economic declines much worse than in Canada or the U.S. and have been slower to return to a growth mode. China remains the best performing large economy in the world with real GDP growth close to its thirty-year average of 9.8 percent a year with no inflation problem. So, we shall see. At least 2010 and 2011 should see the world return to growth after having experienced in 2009 its first decline since World War II.

2009 Stock Market: Year in Review



Bill Hansen, CFA

MANAGING PARTNER

Where We've Been

2009 will go down as an interesting, although stressful, year in the financial markets. Coming off of 2008's -37% total return, the worst market year since 1931, the S & P 500 index began 2009 with a 3% gain to 931 on the first day of trading. At the time, many believed that the inauguration of a new President would be a possible good news event that would lead to sustained gains. Alas, this was not the case and the market proceeded to decline -25% by March 9 to 676. What was the catalyst at the bottom? No one could see. It seemed like the decline would never end.

At the time of this writing, the market has recovered +63% from the recent bottom to 1106. One of the worst declines in market history was followed by one of the sharpest rallies. As we have detailed in our quarterly client correspondence, this to us highlights the dangers of market timing.

Equity Performance by Sector

Technology and materials (steel, chemicals, construction materials, etc.) were two of the four sectors that did the worst for 2008. These sectors have been the best performers so far in 2009.

2008 Worst underperforming sectors:

S & P 500 Index (not including dividends) -39%

Financials -57.9%

Materials -46.9%

Technology -44.6%

Industrials -42.1%

2009 YTD Best outperforming sectors:

S & P 500 Index (not including dividends) +25.3%

Technology +56.1%

Materials +46.1%

Consumer Discretionary +37.5%

The rally in consumer discretionary stocks (retailers) was the most surprising, given concerns about overleveraged

consumers, rising unemployment, and increasing foreclosures.

Equity Performance by Style

The worst performing equity style in 2008 was mid-cap growth, with a -46.6% return. The best was small-cap value, down -32.4%. Everything went down together; some asset classes just went down by more than others. For 2009, the best performing equity style has been, you guessed it, mid-cap growth. Small-cap value has taken over as the worst performing style this year. International stocks did worse than the U.S. market last year but better this year. The moral of the story: it's hard to predict what particular style is going to do better in any given year. In a well-diversified portfolio, you want to have exposure to a variety of styles, companies of different sizes, and domestic versus international investments. Our client's equity portfolios include all of these types of assets.

What's Different Now

With the recent sharp rally in the stock market, some are questioning whether recent gains are sustainable. We would say that the panic has subsided, and that there are a variety of positive factors to consider that point to the possibility of future gains from here.

Companies have cut costs significantly during the recent downturn. They will eventually need to begin hiring again to replenish inventories. Financial firms are deleveraging, meaning they will not be carrying the levels of debt that they were allowed to carry previously. While this will impact their profitability to some extent, it will also make for a safer and less volatile financial system. Banks are beginning to repay TARP funds, which is another sign that financial markets are returning to normal.

Even after the recent rally, the market is still down about 30% from the peak in October 2007. This peak was about the same level as the previous peak back in March 2000. We have endured a nearly 10 year period with a negative total return (dividends plus price appreciation) in the stock market. Historically, this almost never happens. Stock market returns for the current decade have been worse than the Great Depression; and we believe that economic conditions are not nearly as bad as they were back then.

There's always something to worry about: inflation or deflation; a rising dollar or a falling dollar; rising interest rates. A client recently brought in a copy of Life magazine from May 1959 with the headline "Stratospheric Stock Market: Profits, High Pressure, Danger." At that time, the Dow Jones Industrial Average was trading at 625. Since that time, despite all of the political and economic issues to worry about, the Dow has risen to 10,368 after peaking at

14,164 in October 2007 and hitting a recent low of 6,547 in March 2009. This is up almost 16-fold without considering dividends, which would be significant over this time period.

We appreciate the confidence that our clients have shown us through one of the most difficult periods in modern market history. Happy New Year to all of you and your families!

An Unusual Stock Market



Harli Palme, CFP®

FINANCIAL ADVISOR

If there's one thing we can all agree on, it's that 2008 and 2009 were unusual years for the stock market. Stocks crashed precipitously in 2008 and early 2009. Then in March of 2009, the stock market threw up the emergency brake and reversed course, skyrocketing 65% from the

March low to mid-December. We all know that risk is inherent in any investment, but the recent movement of stocks was highly unusual. How unusual was it, and how likely is it to repeat itself? Standard deviation is a statistic that helps answer this question.

Standard deviation is a measurement of how various outcomes are dispersed around the average outcome. Suppose that on an isolated island there are 5000 people of varying heights. On this island the average height is 5 ½ feet. How unusual would it be for the next person born to grow to a height of 7 feet? That depends on the standard deviation of the height pool, or how each individual's height deviates from the group average. If a chart of the data shows that the various heights cluster around the average of 5 ½ feet, give or take a few inches, then it would be highly unusual for the next person born to grow to be 7 feet. But if you find that 25% of people are in the 4-foot range and another 25% of people are in the 8-foot range, then a 7-foot person in the group wouldn't be unusual at all. This example illustrates the notion that if the dispersion of outcomes is large, then the average return is less meaningful. But if the dispersion is small, then more often the actual return falls closer to the average return, and therefore the average return is more meaningful. Standard deviation measures the extent of this type of dispersion.

The standard deviation for stock returns is large for any one given year, but over longer periods of time the standard deviation shrinks considerably. Put simply, the movement of stocks in shorter time frames is far more unpredictable than it is for longer time frames. This is why we say, "Invest for the long run."

The chart below summarizes the outcome of stock return dispersion for a one-year period. Standard deviation gives the probability of a range of returns:

Stock Returns for a One-Year Period

| Number of Standard Deviations | Probability of Given Outcome | Lowest Expected Return | Highest Expected Return |
|-------------------------------|--|------------------------|-------------------------|
| One standard deviation | 68% of the time returns are expected to fall in this range in any given year | -11% | +30% |
| Two standard deviations | 95% of the time returns are expected to fall in this range in any given year | -32% | +51% |
| Three standard deviations | 99% of the time returns are expected to fall in this range in any given year | -52% | +71% |

It might help to think of returns within one standard deviation as "common" and returns outside of two standard devia-

tions to be “unusual.” What about 2008? The S&P 500 returned -37%! According to this information, 95% of the time you would not expect a return below -32%. This indicates that 2008 was highly unusual. Yet the return for 2009 fell in the range of one standard deviation, which is a much more common occurrence. To sum up: 2008, -37% return, unusual; 2009, about 25% return, common.

More important, however, is the fact that the expected range of returns for stocks reduces the longer your timeframe is for investing. The standard deviation for 20-year rolling periods in the stock market is much smaller than it is for 1-year periods, meaning that the average annual return for 20-year periods is closer to the average stock market return. Not all assets have such large variance in returns. Fixed income returns vary less over time, but have a lower average return, dragging the entire expected range downward.

Stock and Bond Returns for a 20-Year Period

| Number of Standard Deviations | Probability of Given Outcome | Stock Expected Range of Returns | Bond Expected Range of Returns |
|-------------------------------|--|---------------------------------|--------------------------------|
| One standard deviation | 68% of the time returns are expected to fall in this range in any given 20-year period | +5% to +14% | +4% to +8% |
| Two standard deviations | 95% of the time returns are expected to fall in this range in any given 20-year period | 0% to +19% | +2% to +10% |
| Three standard deviations | 99% of the time returns are expected to fall in this range in any given 20-year period | -4% to +23% | -1% to +12% |

Though bond returns vary less than stock returns, the average return is lower. In any one given year the downside risk of bonds may seem more comforting, but when you look at the expected range of returns over 20 years, you see that the downside of stocks is actually not much worse than bonds, and the average return is much higher (9.6% average return for stocks, 5.7% for long term government bonds).

For investors who want growth, or who have a high required rate of return (due to various financial goals or spending needs), having a significant portion of your investments in stocks and a long time frame in which to invest is statistically your best bet. The difference in 9.6% average return for stocks and 5.7% average return for bonds is significant. If you invested \$1 million in each for a 20-year period (that actually earned that average return) you would have \$6.2 million in the stock portfolio and only \$3 million in the bond portfolio. That difference could mean having \$125,000 less to spend annually in retirement.

What if you're already spending? Say you have a \$1 million portfolio from which you spend 4% annually. You can invest in an 80% stock/20% bond portfolio, or in a 100% bond portfolio. The 80/20 portfolio spender would have \$2.3 million in 20 years, whereas the all bond portfolio spender would have just \$1.4 million in 20 years. Once you factor in inflation, those portfolio amounts are \$1.25 million (80/20) and \$775,000 (100% bonds) in today's dollars. The 100% bond portfolio has lost money on an inflation-adjusted basis.

Obviously, making more money is desirable, but over the last two years many investors found that they couldn't sleep at night with the volatility that the stock market brought to their portfolios. It was an extreme (and statistically unusual) scenario that opened investors' eyes to the risk inherent in the market. You have to weigh your ability and willingness to withstand risk, your timeframe (plan to need your money until age 100, *just in case*), with your desire, and need, for higher returns. Your financial advisor is here to talk to you about this balance if you have concerns.

And to the skeptics: Yes, this decade has shown us some of the worst years in stock market history, but has it been *unusual*? Over the last 10 years the total return for large company stocks was about zero. But for the last 20 years, even with the worst decade ever, that return has been about 6%. And while it may be nothing to write home about, the longer-term view

is most certainly less of a wild ride than the recent short-term period.

Note: Analysis of standard deviation assumes that returns are normally distributed around the mean. Stock returns appear to have more occurrences above the mean than below, but have negative outliers. The standard deviation method described is the most widely used statistic to describe the variation of stock returns and the best one available, despite its limitations.

Important Information for Client's Receiving Schwab Statements

Those of you with accounts at Schwab will notice that cost basis will now be listed beginning with your January statement. If a zero is listed for a position, the security was purchased elsewhere and Schwab does not have this information. Please review your statements, and feel free to submit any missing basis information to us so that we may update your account. If you have already submitted this information to us, but it does not yet appear on your Schwab statement, please be advised that we will be submitting it to Schwab in early 2010.

Note that the cost basis for positions in retirement accounts such as IRAs and Roth IRAs is not needed for tax purposes; therefore you do not need to submit this information unless you prefer to have it to be displayed on your statement. If you have any questions, please contact client service or your advisor.

ParsecFinancial
WEALTH MANAGEMENT

6 Wall Street
P.O. Box 2324
Asheville, NC 28802
Office: 828.255.0271
Fax: 828.255.8951
Toll Free: 888.877.1012