StoneRidge WM
June 2010

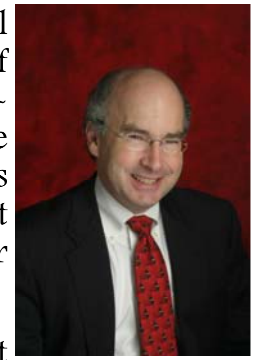
The Next Surprise

The Quarterly Profit

A little over a year ago, the global markets began to recover from the worst shake-down since the Great Depression. The recovery has been erratic and will probably maintain a tortured rhythm for at least another year. Our own recovery seems to be outperforming many of the wealthy nations, but we are still facing disturbingly high unemployment numbers. And, just when it appeared that positive trending was taking hold, along came the European credit crisis to quickly erase all market gains since early February. How can we incorporate the lessons from the 2008 debacle and recovery, and how do we prepare for an uncertain future?

First, let's review the four fundamental laws of economics: (1) an incoming tide floats the boat (2) an outgoing tide exposes those who are swimming naked (3) investment bankers make obscene bonuses even if they can't swim or row 4) financial pirates will always pillage and plunder no matter what regulations are in place. Let's not dwell on # 3 and # 4 because we can't personally control the bankers or the pirates. If we run their DNA through the lab, we will see their little strands of nucleotides spelling G-R-E-E-D.

Do you remember the Bell Shaped Curve from statistics, and how 2/3 of the time we can "reasonably" predict certain occurrences? This model may be useful while predicting the mating habits of fruit flies, but it doesn't work so well in retirement planning. "If you place fifty men and fifty women in a room, we know that the average person has only one breast". These old statistics jokes aren't very funny when applied to our own personal retirement security. If we rely on the statistician's "averages" we might find ourselves with little retirement money and another ten years to live.



The disastrous market events that will hardly ever happen seem to occur more often than the averages suggest. There was a severe credit crisis in the early nineties, the tech bubble bursting in 2000 and 2001, the attacks of Sept. 11, the Enron bankruptcy, a hurricane that destroyed New Orleans, a subprime crisis that nearly tanked the global markets in 2008, and a European credit crisis that has recently sent shockwaves around the world. How much more evidence do we need? Throw in a volcano that shut down all air traffic in Europe, plus an oil rig catastrophe that will alter the entire ecosystem of the Gulf, and we have a set of statistics that cannot be ignored. Why not simply assume that the global markets will be seriously disrupted every few years and build our portfolios accordingly? A careful and flexible balance of safety, fixed income, and growth is hardly a new concept, but it is more important now than ever before.

My personal opinion is that the global economies are heading into a prolonged period of growth, driven by the economies of the emerging markets and the many exciting aspects of globalization. Let's design our investments to embrace these opportunities, while creating a solid safety net in preparation for the next surprise; it's out there waiting for us.

Van Mason, CFP™, CLU, MBA

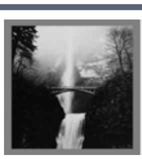
Purchasing Real Estate with Your IRA

Clients sometimes ask me whether or not they can purchase real estate within their retirement account. The answers are “No, you can’t”, and “Yes, its possible, but I don’t recommend it” First, if we want to buy that cute little cabin by the lake, we cannot purchase it and hold it as an IRA asset. This is because the tax code prohibits purchasing any real estate with IRA money for personal use. (Please note, that if we cashed in an IRA, paying all taxes and possible penalties, this money would no longer be within an IRA account) Second, the code prohibits any “self dealing”. In other words, we cannot sell property to our IRA or buy property from it, or lease to/from our IRA. We can’t borrow against the IRA (unless we return the money within 60 days) or use it as collateral for a loan.

When it comes to investment property, the answer is different. First, we can purchase real estate mutual funds, real estate stocks, or privately traded Real Estate Investment Trusts within our IRA accounts. We can also invest in limited partnerships that purchase properties, but we cannot exercise control over those same limited partnerships or we violate the IRS self dealing rules. Let me emphasize that I am not recommending any of these investments, and that any such real estate investments can lose substantial value. For the record, I am adamantly opposed to investing with local or regional real estate companies that exist solely for the purpose of investing your IRA money in real estate; I have seen too many instances where the client’s properties end up in foreclosure and most of the equity lost. While some real estate agents believe that investing their IRA money in real estate is a good idea, the numbers simply do not add-up.

Even if the investor is able to comply with the IRS self-dealing provisions, many of the fundamental advantages of real estate are lost when purchased with IRA money. First, the real estate cannot be purchased unless it is for 100% cash. This is because of the code provisions that prohibit lending to the IRA. From a practical standpoint, real estate loses much of its investment appeal if there is no financial leverage. Technically, there could be a mortgage if a lending institution allowed a “non-recourse” loan, where the investor did not have to personally sign for the loan. However, the chances of finding such a Santa Claus are slim to none. Another major problem is how to pay for unexpected property repairs. Because the code prohibits loans to the IRA, money cannot be contributed unless it is in the normal scope of annual contributions. But contributions are only allowed if the investor is working, so what does a retired investor do? And, even if the investor is working, the limitations imposed upon scheduled contributions may not be enough to cover required expenses.

Tax planning is another area where real estate within the IRA is questionable. While the investor’s contributions to an IRA are tax deferred, the tax advantages normally associated with real estate investing are lost. First, all/any profits from the eventual sale will be taxed at ordinary income rates rather than capital gains rates. Second, for estate planning purposes, there is no “step-up” at the time of death as with non-IRA real estate. Usually when a property is inherited, the cost basis to the heir is the value of the property on the date of the decedent’s death, so an immediate sale will usually result in little or no taxes. This does not apply to property in the IRA. <u>All</u> proceeds from the sale of inherited IRA property are taxed as ordinary income, not just the profits. Moreover, if the property is not sold, and is inherited as a beneficiary IRA, it is subject to required minimum distributions based upon the age of the beneficiary. RMD’s (Required Minimum Distributions) from real estate can be a financial nightmare. As an example, a $600,000 triplex will require a distribution of about $22,000 in the year the investor turns 70 ½. To satisfy this requirement, a deed for 1/27.4 must be issued to the investor as a distribution, and then taxes must be paid on this non-cash receipt. Ouch! Bottom line recommendation? Forget About It!



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