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Managing A Concentrated Stock Position Wisely

The bear market was full of reminders of the perils of holding concentrated stock positions. In the financial sector alone, many former titans saw their share prices fall precipitously (and a few disappeared altogether). Though concentrated positions sometimes also provide extraordinary gains, a broad mix of investments holds a lower probability of loss. That doesn't mean you should immediately sell a concentrated stock position and replace it with a diversified portfolio—there are tax costs and other factors to weigh—but it does argue for managing them wisely.

Even if you discount the likelihood that a particular holding might lose most of its value, stocks' volatility could limit your investment gains. "The Hidden Cost of Holding a Concentrated Position[1]," a recent study by investment firm Robert W. Baird & Co., compares a hypothetical stock-and-bond portfolio to the 272 stocks that were in the Standard & Poor's 500 stock index from March 31, 1999 through March 31, 2009. The hypothetical portfolio, with 60% of assets in a broad mix of stocks and 40% in taxable bonds, outperformed most of the individual stocks, whose average volatility was four times that of the diversified holdings. (Volatility, often measured in terms of standard deviation, considers changes in the market price of an investment; the more sharply the price tends to rise and fall, the greater the stock's volatility.) And while 160 of the stocks failed to keep up with inflation—and 104 lost 20% or more—the hypothetical diversified portfolio produced a 45% gain for the decade, according to the Baird study.

One reason the diversified portfolio did so much better has to do with volatility's effect on compounded investment returns. The Baird study considers two hypothetical holdings that produced the same average annual returns during a two-year period but had very different levels of volatility. The first investment gained 50% the first year but lost 30% in year two, for an average gain of 10% and a volatility of 40%. The second investment gained 15% and 5%, respectively—also an average 10% gain but with volatility of just 5%. That makes a big difference in the performance of a $1 million investment in each holding. The first would jump in value to $1.5 million after one year before dropping back to $1.05 million after the second year, for compounded annual growth of 2.5%. The second investment, in contrast, would have been worth only $1.15 million after one year but $1,207,500 after two—a compounded growth rate of 9.9%.

So if diversification tends to provide reduced volatility, and that in turn may translate into better results, why would anyone hang on to a concentrated stock position? There may be many reasons, including legal restrictions on selling shares in an employer. But tax costs may be the biggest stumbling block. If you sell shares that have appreciated significantly

(Continued on page 4)

Goodwill Will Take Your Old Electronics

Remember when every neighborhood had an electronics repair shop where you could trade in your old stuff or get it fixed? Nowadays, American homes and businesses dump a staggering 41 million computers, 27 million televisions, and 140 million cell phones every year, largely because we have no idea what to do with all those devices when they break down or just get old.

Most of the hardware ends up in landfills or incinerators, which turns the waste of perfectly good components into an ecological nightmare, with dangerous metals escaping into the air or seeping into groundwater. But even if your old computer is in good shape, a lot of charities and schools won't take it because they're already flooded with everyone else's hand-me-down machines.

The good news is that Goodwill will now accept your electronic devices even if they're broken. Just take a look at reconnectpartnership.com and see if any of the1,900 locations that currently support this program are convenient to you. (Some will even pick up computers, TVs, or other equipment for a small added fee.)

They'll refurbish, resell, or break down your gear for recycling. You'll get a tax receipt; in general, working computers are worth a $100 to $500 deduction, printers and scanners $25 to $100, and even those clunky old monitors will get you at least a $10 tax write-off.

Robert J. Pyle, CFP, CFA

Do A Direct 401(k) To Roth Rollover

In the not-so-distant past, it wasn't particularly easy to roll over funds from a 401(k) plan to a Roth IRA, which can provide tax-free income during retirement or for your heirs. Now, it's a relative snap. What's more, the IRS has provided new guidance on how to complete this maneuver.

Prior to the Pension Protection Act of 2006 (PPA), it took two steps to complete a 401(k) to Roth rollover, and it was possible only if your income didn't exceed a specified limit. First, you transferred funds from your 401(k) to a traditional IRA. Next, you converted the traditional IRA to a Roth, paying income taxes on the amount of the conversion. But you could do this only in a year in which your modified adjusted gross income (MAGI) didn't exceed $100,000.

The PPA fixed part of the problem. Beginning in 2007, you were allowed to roll over funds directly from a 401(k) plan to a Roth, bypassing the traditional IRA. But you still might have been blocked by the $100,000 limit.

That impediment no longer exists. Based on a tax law change that took effect in 2010, you may now convert to a Roth regardless of your annual MAGI. And, for conversions completed in 2010, you can split taxable conversion income between 2011 and 2012. That lets you postpone the tax hit of converting to a Roth, and you may pay less overall if the smaller taxable amount keeps you out of a higher tax bracket.

The IRS recently issued rulings clarifying aspects of a direct rollover. The guidance included these points:

• You can convert to a Roth IRA from retirement plans including 401(k)s, 403(b)s, and 457(b)s.

• A direct rollover to a Roth isn't subject to automatic 20% withholding. But you can agree to voluntary withholding.

• Beneficiaries may make rollover contributions to Roth IRAs. Also, surviving spouses who complete a rollover to a Roth IRA may treat the Roth IRA as their own.

• If funds in a designated Roth 401(k) account are rolled over to a Roth IRA, the rollover isn't taxable, whether or not the transfer is a "qualified distribution."

• Other transfers, except for amounts representing after-tax contributions to your plan, are taxable.

• If you own company stock in a 401(k), you will not be taxed on the "net unrealized appreciation" (NUA) of the stock when it's distributed. But you can't avoid tax on the NUA by rolling over assets directly to a Roth.

• If you're married, you no longer need to file a joint return to benefit from the rollover provisions.

This is just an overview. We can work with you to weigh the merits of a Roth conversion and help you follow the rules governing such transfers. ●

Critics Overlook Advantages Of A 401(k)

The U.S. economy has served up plenty of negatives in the past couple of years, including a stock market that hit 12-year lows and 140 bank failures in 2009 alone. So it's not surprising that financial institutions and products have come under fire.

But in some cases, critics seem determined to throw out the baby with the bath water. That has certainly been true of the 401(k) retirement plan. Introduced during the great bull market of the 1980s and '90s, the 401(k) seemed a perfect alternative for companies that didn't want the expense and hassle of a traditional pension plan. The 401(k) let employees put away pre-tax dollars, and employers could offer workers matching contributions. Any company without a 401(k) was at a competitive disadvantage in recruiting top employees.

When the stock market plummeted in 2008, however, many 401(k) participants suffered big losses—just as almost every other investor did—and that led to claims that the 401(k) itself should be put to rest. A Time magazine cover story opined that "the ugly truth is that the 401(k) plan is a lousy idea, a financial flop, a rotten repository for our retirement reserves."

Wait a minute! Sure, these retirement plans have flaws—for example, some carry unreasonably high expenses and insufficient investment options. But they're still the best option for many employers looking to help employees save for a secure retirement. Here's why:

1. The 401(k) remains an important recruitment tool, particularly for small companies. It's a perk that helps employees feel they're being given something special. Workers know they can contribute to their own savings success and that their employer will help them.

2. The 2006 Pension Protection Act provides a "safe harbor" that lets your plan avoid the non-discrimination

Asset Protection For Desperate Times

Even in the best of times, people with significant assets may find themselves on the wrong end of a lawsuit. Most physicians, for example, will be sued for malpractice at least once during their careers, and they pay high premiums for liability insurance, which may not cover the entire exposure. Other professionals and business owners also are frequently dragged into court, and adverse judgments may put family assets at risk.

But if the wealthy are targets of lawsuits even when the economy is strong, they're all the more vulnerable these days, when financial desperation may motivate people to take a legal shot at anyone for any reason. And if a judge or jury sides with the plaintiff, a defendant could lose business interests, investments, or other property.

In some states, the simple act of purchasing life insurance and annuities can help to protect assets. But whatever strategy you follow, you need to act before there's a problem. If you're already being pursued by creditors or embroiled in a lawsuit, the courts may disregard moves to shield your property.

Consider these possible asset-protection strategies and vehicles.

Transferring property. One simple way to protect assets is to give them away. You can transfer as much property as you like to your spouse (if a U.S. citizen) free of estate or gift tax, and under the annual gift tax exclusion, you can also make gifts of up to $13,000 a year to anyone else. Moreover, you're entitled to a lifetime, cumulative gift tax exemption of $1 million. But making property gifts means relinquishing control, and spousal transfers may create estate tax complications.

Forming a corporation. If your fortune is tied to business interests, a traditional method for avoiding personal liability is to establish a C corporation. In the absence of fraud, you normally won't be liable for corporate debts, but you also aren't necessarily protected against professional liability if you are a professional. The personal liability protection of a C corporation is not impregnable, however, as the courts have increasingly allowed persistent plaintiffs to "pierce the corporate veil" and reach a defendant's personal assets.

Other corporate variations, such as S corporations and limited liability companies (LLCs), offer protections similar to those of a C corporation, and those alternative business structures may give you tax advantages. Generally, a C corporation is taxed twice—the business pays income tax, and then you're taxed on the dividend you receive—whereas S corporation shareholders and LLC members get only a single tax bill. The LLC format, compared with the older S corporation, has fewer restrictions, but may have higher taxes in some states.

Owning assets jointly. Another long-standing asset protection strategy is to title property as joint tenants with your spouse or another family member. If assets are owned by "joint tenants with rights of survivorship" (JTWROS), they automatically pass to the survivor upon the other owner's death. A special type of co-ownership only between a husband and wife, known as "tenancy by the entirety" (TBE), may protect assets from creditors. More than half the states now recognize TBE protections.

In the nine community property states, on the other hand, property acquired during a marriage is generally treated as being owned by both spouses, regardless of how it is titled, and could be accessible to creditors of either spouse.

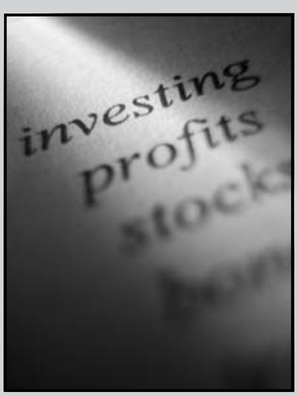
Domestic trusts. Various kinds of trusts created within the United States can help shield assets from creditors. For example, you could establish a "spendthrift trust" for a child. Normally, that involves transferring control of trust assets to a designated trustee, who will manage the trust. Creditors can't touch the assets before the beneficiary actually receives a distribution. The maximum protection is obtained with a discretionary trust which does not require distributions to be made at any particular time.

Self-settled trusts. A self-settled trust is one you form for your own benefit—you're the beneficiary as well as the grantor. Currently, 11 states allow you to establish self-settled trusts to protect assets from future creditors. To qualify, the trust must generally adhere to the laws of the state, have a trustee resident in such state, and be irrevocable.

Foreign trusts. A foreign or "offshore" trust can be a legitimate means for protecting assets by subjecting the property to the more lenient laws of a foreign jurisdiction. But foreign trusts also have disadvantages, including tax reporting requirements, lack of tax benefits, and concerns about trustees.

Devising an effective asset-protection plan is often complex and subject to crucial missteps. We can work with you and your attorney to create a plan that provides effective legal protections. ●

testing that's normally required to ensure that highly paid executives don't reap disproportionate benefits. If you automatically enroll all new employees (letting them opt out if they choose) and deduct 3% of their salary to contribute to the plan the first year, then 4%, 5%, and finally 6% in subsequent years, you need not test for discrimination—and may be able to offer more generous benefits to top management.



3. Some plan sponsors elect to match a percentage of employees' salary, contributing, say, 3% to workers' accounts. That's another way to avoid non-discrimination testing.

4. The 2006 act also encourages employers to retain financial advisors to provide one-on-one investment advice for employees—an option that could increase the value of your plan to its participants.

The 401(k) will not go away and remains the dominant way for employees to save for retirement, though some reforms may be on the horizon.

Don't Trust Your Roth To The Kids

Now that the barrier to Roth IRA conversions has finally fallen, you may opt to shift assets from your traditional IRA. But whom will you designate as beneficiaries of the new Roth account? Rather than having it go directly to children or grandchildren, you could name a trust as beneficiary. That option will prevent younger heirs from squandering the funds, and it could stretch the life of the Roth IRA by many decades.

A main attraction of a Roth is that qualified distributions are completely exempt from federal income tax. Furthermore, unlike a traditional IRA, a Roth doesn't require you to begin taking annual minimum distributions after age 70½. If you don't need the cash, you don't have to touch the account.

Before 2010, you couldn't convert a traditional IRA to a Roth during a year in which your modified adjusted gross income exceeded $100,000. But that income ceiling is now gone, and though you'll pay income tax on the amount of the conversion, if you make the switch in 2010 the taxable income will be split over the following two years (unless you elect to report 100% of the income in 2010).

Choosing whether to convert your traditional IRA involves weighing several factors, including your age, your expected tax rate in retirement, and whether you have non-IRA funds to pay conversion taxes. But if converting your account seems wise, you still have to decide whom to name as beneficiaries, and if your children are well established financially, you might decide to leave the account to your grandchildren instead. That could extend the life of the Roth and its tax-free distributions. But it also risks putting large sums in the hands of those who may be too young to handle them responsibly. This is a concern when naming beneficiaries for any asset, not just Roth IRAs.

Designating a trust as the beneficiary could provide extra protection. The money can still ultimately go to your grandkids, but the trust could delay distributions until they reach the age of majority or even longer. In the meantime, a professional trustee could manage the Roth assets, potentially adding to their value during the years until the grandchildren come of age.

Though you don't have to take distributions from a Roth IRA, your heirs will have to make withdrawals, and that's true even if the assets go into a trust. The minimum annual payout will be based on the life expectancy of the oldest heir at the time of your death. So, for example, if your oldest grandchild is age 12, the remaining life expectancy will be about 70 years. But if you're leaving the account, through a trust, to beneficiaries whose ages vary widely, you may want to consider dividing it into two or more trusts, to extend the life of the Roth—and its potential growth—as long as possible for the youngest heirs. We can work with you, your attorney, and your tax advisor to see whether a trust makes sense in your situation. ●

Managing Stock Wisely

(Continued from page 1)

since you bought them, you could find yourself paying today's 15% tax on long-term capital gains on almost the entire proceeds (unless you have large capital losses from this year or a prior year to offset your gains)—and that knocks a large hole in a new, diversified portfolio.

There are several alternatives to selling all at once. You might offset some risks of further concentrating your position by avoiding that holding's company and industry in the rest of your portfolio. You could divest your shares gradually in order to stretch out your tax liability. Very wealthy investors may be able to put a portion of concentrated holdings into an exchange fund, which avoids immediate taxes and gives investors shares in a diversified portfolio. Using some of the stock position to fund charitable goals could provide tax advantages and income, and company insiders might use a preprogrammed selling program known as a 10b5-1 to unload restricted shares.

Five Ways To Manage A Concentrated Stock Position
1. Avoid similar holdings in the rest of your portfolio
2. Divest your shares gradually to stretch tax liability
3. Fund charitable goals with part of your holding
4. Put a portion of the stock into an exchange fund
5. Use a 10b5-1 preprogrammed selling program

All of those possibilities involve complex planning issues and need to be considered in view of your overall financial goals. For example, the current capital gains tax rate is the lowest it has been in many decades and may rise soon, and that could make it advantageous to incur those taxes now, not later. We can work with you to assess the vulnerability of a concentrated stock position and help you manage it wisely. ●

[1]The hypothetical stock portfolio in the Baird study had 12% of assets in large-cap growth, 14% in large-cap value, 8.5% and 3.5% in mid-cap and small-cap shares, respectively, 14% in international holdings, and 8% in a mix of "satellite" investments (emerging markets, high-yield bonds, commodities, and real estate).

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