the EDUCATED INVESTOR

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LGC&D Wealth Management, LLC
A Registered Investment Advisor

The Pension Protection Act of 2006

How does it affect YOU?

The Pension Protection Act has recently been signed by the President into law. Here are just a few provisions that could be good news for you.

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Inheritance rollovers for non-spouse beneficiaries: Under current law only spouse beneficiaries can roll inherited retirement plan assets into an IRA. Non-spouse beneficiaries are generally required to take a lump sum distribution and pay taxes on what are usually zero basis amounts. The new law would extend the rollover option to non-spouse beneficiaries for distributions made after 2006, enabling many beneficiaries to defer the distributions (and subsequent tax liabilities) as they would with any other IRA.

Direct deposit your IRA contribution: Checking, savings or IRA? The IRS will now be required to develop and make available to taxpayers an option allowing you to have all or a part of your federal tax refund direct deposited into your IRA account (or your spouse's IRA, if you file a joint return).

Good news for 529 plans: You may already have established or contributed to one of the many 529 plans available to help fund expenses related to higher education. The Pension Act permanently extends many of the highlights of 529 plans, such as being able to make 5 years' worth of contributions at once, or the ability to "roll" the assets to a cousin as beneficiary, that were originally slated to expire for tax years beginning after 2010.

Why not give away your IRA?: The new Act allows taxpayers to exclude from gross income up to $100,000 of what would otherwise be taxable traditional or Roth IRA distributions when the distributions are given to a charitable organization. To qualify, the donation must be made directly by the Trustee after the IRA owner is 70 and one half years old. The best part - contributing to a charitable organization with funds from your IRA can satisfy your required minimum distribution. And since the distribution is never included in your gross income, the amount of tax you pay on social security may be reduced and you are less likely to lose other tax breaks to the AMT.

Call me at 401-421-4800 or email me at jdorfman@lgcd.com if you want to learn more about any of these or the other provisions included in the Pension Protection Act of 2006.

Navigating a Volatile Market

If the market were a river on which the investor rides, periods of low volatility are when the banks are wide and the current smooth. These are the times you can sit back and float. Then there are the rapids, the periods of higher volatility. Your journey accelerates and may turn wild. Recent markets might be compared to medium-level rapids. While we've seen much worse, we've also all been enjoying a relatively long, mild run leading up to this past spring.

Those who overreact to turbulence may find themselves needing swimming lessons fast. In contrast, rely on prudent advice to guide you through, and you can expect to remain on course — onward toward your long-term goals. Following are three key navigation techniques to employ,

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The Academic Wisdom of Diversification

A fundamental tenet of Modern Portfolio Theory (MPT) is that effective diversification reduces the volatility and dispersion of returns — without reducing expected returns. In other words, with proper diversification, you can maximize expected returns for a given level of risk.

Academic theory aside, most of us intuitively sense that diversification makes good sense. But too often we've seen the concept ill-defined as sitting on a lot of eggs, without the sufficient number of baskets — or asset classes — to contain them.

It's not just how many securities you hold. It's holding them across an appropriate range of asset classes. Economist Harry Markowitz was among those who were instrumental in developing MPT; for his efforts, he was one of three who was co-awarded the 1990 Nobel Prize in economics. In the 1952 *Journal of Finance,* Markowitz observed that effective diversification depends not only on the number of assets in a portfolio, but also on the ways and degrees in which their responses to economic events tend to reinforce, cancel or neutralize one another.[1]

For example, depending on each investor's objectives and risk tolerance, we first suggest an appropriate allocation between stocks (equities) and bonds (fixed income). Within equities, we typically recommend diversifying across the domestic equity asset classes of small-cap and large-cap companies, as well as into value (distressed) companies depending on the individual's risk profile. When appropriate, real estate and commodities asset classes are blended into the mix. To achieve global diversification, it is often prudent to add a significant allocation to international equity asset classes, sometimes including emerging markets.

Over time, portfolios that were designed to consistently capture this level of broad, global diversification have benefited, and have typically done so with less volatility.

This is not to say that a globally diversified portfolio is always outperforming a more concentrated approach at any given point in time. For example, between 1981–2005, there were 10 years out of 25 in which a more concentrated portfolio (60 percent S&P 500 Index/40 percent bond index) outperformed, *for as many as four years in a row,* compared with a portfolio containing significantly more diversified index-based allocations. Yet, over the 25-year period, the diversified portfolio yielded a measurably higher annualized return and less volatility.

It is precisely when diversification may not seem to measure up that a trusted advisor can play a particularly crucial role. The academic evidence captured by MPT demonstrates why markets are largely efficient over time, and generally favors a broadly diversified approach. A good advisor can keep you on track and make sure that your investment approach remains consistantly diversified.

[1] Trone, Allbright and Taylor, *The Management of Investment Decisions.*

Rebalancing for Well-Designed Growth

The Fine Art of Rebalancing

Rebalancing is the process of restoring your portfolio to its original asset allocations and risk profile. Because each asset class within your portfolio is likely to shrink or grow by a different percentage over time, maintaining your portfolio's original design is an ongoing process, not unlike periodic maintenance of a carefully shaped topiary.

As an added bonus, rebalancing helps you develop sound, long-term investment habits. By trimming allocations that have been recently outperforming, and expanding on those that have been recently underperforming, you are naturally adopting a desirable "buy low and sell high" approach.

At the same time, rebalancing your portfolio too often or too severely can be costly. Doing so usually entails transaction costs and potentially taxable realized gains. A delicate balance is required to help your portfolio maintain its intended shape — without pruning too much of your wealth away. Following are some strategies that we help our clients implement... *Continued on pg 4* ***Growth...***

Year-Round Tax-Loss Harvesting

Sometimes you *can* win by losing — and in fact savvy investors do so year-round. One way we add significant value to your investment experience is by keeping a continuously vigilant eye out for tax-loss harvesting opportunities, and helping you appropriately act on them when they occur.

What Is Tax-Loss Harvesting?

Tax-loss harvesting is the practice of selling securities when they have incurred losses, and then typically repurchasing them after an appropriate waiting period. Within guidelines defined by U.S. tax code, both short- and long-term capital losses can be used to offset current or future short- and long-term gains, respectively; in some circumstances, the losses can even be used to offset ordinary income.

Implemented properly, tax-loss harvesting can be a win-win situation. But "implemented properly" is key. Following are just a few considerations that we factor in as we assist clients with this valuable service.

Knowing When To Act

We seek tax-loss harvesting opportunities whenever they may occur — not just at year-end. But it is also important to accurately assess when a loss harvesting opportunity is likely to be advantageous, versus when the costs or risks involved are expected to outweigh the benefits. This takes a great deal more than just spotting a security with a price loss. A host of related assessments include the nature of the loss, the amount of the loss, transaction costs involved, current tax code and your individual profile.

Seeing the Big Picture

As losses are harvested, it is important to ensure that the transactions do not interfere with your portfolio's carefully planned asset allocation policies. Because big market gains can occur very rapidly, we recommend even interim holdings remain as fully and accurately invested as possible, rather than sitting as cash or cash equivalents.

Following the Rules

At the same time, several steps must be taken to ensure that the IRS doesn't disallow the loss. While interim holdings should resemble your original holding (to maintain the integrity of your overall portfolio), they must be different enough that they aren't deemed "substantially identical." In addition, the period of time between transactions must be carefully considered, to avoid what is known as the "wash sale rule."

Short-Term and Long-Term Considerations

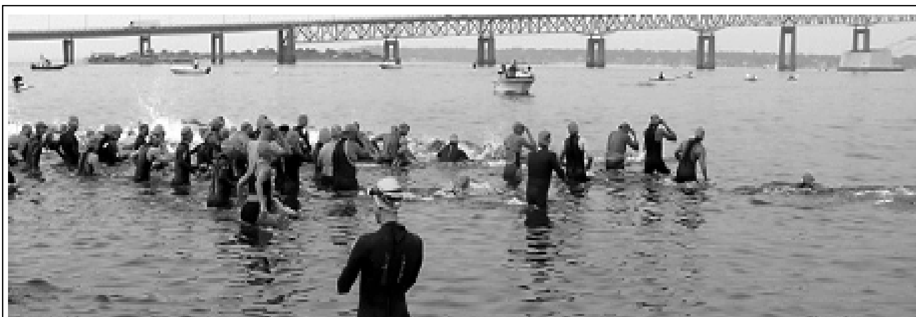
A more thorough discussion with your tax consultant and investment advisor is warranted, but another consideration when harvesting losses is whether they will be short- or long-term. Short-term losses are first deducted against short-term gains that would otherwise be taxed as ordinary income. Long-term losses are first deducted against long-term gains that would otherwise be taxed at the lower capital gains rate. For example, if you have (or plan to have) realized short and long-term gains, and unrealized short-term losses, it might be advantageous to realize the losses before they become long-term.

Managing the Risks

As the harvesting occurs, adjustments and additional guidance may be warranted to achieve a positive outcome. In fact, in our unpredictable market, even when all steps are properly executed, results can and do vary. For example, what happens if you sell Fund A at a loss, place the proceeds in interim holding Fund B, and then end up facing a short-term capital gain if you sell Fund B to repurchase Fund A? Should you complete the transaction anyway? There is no one correct answer; the decision depends on what is best for your unique situation, and one of many reasons that our clients rely on us to provide expert guidance in making the most of their investments.

REMINDER

Larry E. Swedroe Presents...
Simple Truths You Must Know When You Invest
September 26, 2006 from 5:30-7:30 at Save the Bay, Providence, RI.
Seating is limited, call 401.421.4800 to reserve your space.



Congratulations to Jerry Dorfman

for his participation in

Save the Bay's 30th Annual Swim across Narragansett Bay

JULY 29, 2006 — A record-shattering 421 swimmers splashed their way across Narragansett Bay from Newport to Jamestown. For the 30th year, the Save The Bay Swim symbolized the community of care that surrounds the Bay. Once the final pledges were tallied, Save The Bay raised more than $150,000 to support efforts to ensure the Bay's health and future.

For more details visit http://www.savebay.org/news_06swim_final.asp

Growth cont....

Cash Is (Often) King

Rebalancing is generally most efficiently accomplished using new cash to purchase assets that have been the recent underperformers "on sale." Applying new cash to wherever increased allocations are needed (rather than having to sell existing holdings to purchase others) helps minimize trading costs and taxable capital gains.

One way to obtain "new cash" is from dividend distributions of securities you already hold. Consider requesting such distributions as cash rather than as automatic reinvestments. You can then use the proceeds to rebalance wherever is needed. (However, this tactic does not work as well if the dollar amounts are too small.)

Tax-Conscious Investing

Of course rebalancing can occur within your tax-sheltered accounts with more ease, since tax ramifications won't apply. In general, avoid rebalancing taxable accounts if doing so would result in realizing short-term capital gains, which are taxed as regular income. Instead, it may be prudent to wait until they become long-term gains, or until new cash can be used instead. For example, you may choose to delay rebalancing if you are expecting assets to become available within a relatively short timeframe — such as proceeds from a maturing bond or the planned sale of a security or other asset.

However, there are times when you may decide to incur taxable capital gains rather than wait to rebalance. If you have capital losses to offset your gains, you might proceed (although, first, a conversation with your tax consultant is warranted). Or, if you and your investment advisor determine that your portfolio is significantly out of balance, you may decide that the overall benefit to reallocating your portfolio will still offset the taxes incurred in doing so.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An investment approach based on research by Nobel Prize-winning economists
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... <u>A TRUSTED ADVISOR RELATIONSHIP</u>**

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