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The weather has turned hot, and the market remains volatile, although we're now into a third consecutive year of an overall upward trend.

Washington continues to do what it does best... bicker and create headlines. Inflation represents an arena heavily scrutinized by government and frequently cast into the media spotlight, so I've included some information in this newsletter regarding that subject, as well as a few other areas I think you'll find interesting and informative.

Thank you for your business. It's a privilege to work with your toward your financial goals.

-John

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Inflation or Deflation: Watching for Warning Signs

There's been much debate in investing circles over the last year about whether inflation or deflation represents a more likely threat to the future of the U.S. economy. With a recovery that's still tentative compared to previous recessions, measures designed to stimulate the economy or cut spending to rein in the budget deficit provoke warnings about their potential to create one or the other.

The case for inflation

As the economy has begun to recover, worries about the potential for future inflation have become widespread. The Fed has undertaken extraordinary measures to make sure there is plenty of money in circulation, but some experts worry that the increased money supply will eventually cut the dollar's purchasing power, especially if interest rates are kept at historically low levels for too long. They cite the easy availability of money as contributing to the late-1990s tech bubble and the mid-2000s housing bubble, and fear that another could be on the way.

The Federal Reserve Board's monetary policy committee maintains that inflation currently is too weak to support normal economic growth, let alone launch an inflationary spiral. However, those who see inflation in our future watch for warning signs such as increased Treasury yields, particularly on longer-term bonds. Higher yields when bonds are auctioned suggest that investors are increasingly wary of tying up their money for long periods at a fixed interest rate if they feel that inflation is going to erode the buying power of those fixed payments over time. Wholesale prices also are watched closely; higher prices at the wholesale level can be a precursor of higher prices at retail (that is, if retailers are able to pass those costs along to buyers, which is not always the case).

The case for deflation

At first blush, the falling prices that characterize deflation don't sound like such a bad thing. Who wouldn't like to be able to buy things for less than they cost now, especially when times are tough? The problem is that those falling prices can harm the economy in several ways, as Americans were reminded during the recent recession. When prices are dropping, people tend to postpone purchases, hoping to pay less in the future (consider what's happened with real estate since 2007). Delayed spending puts pressure on corporate profit margins and companies tend to cut spending themselves, creating financial difficulties for companies that rely on business spending. Cutbacks begin to ripple through the economy.

Deflation typically affects not only prices but wages; scarce jobs can lead to pay cuts even for those who stay employed. And lower incomes can start a new round of cost-cutting by both consumers and business. If this process sounds familiar, it's because for much of 2009, the U.S. experienced negative annual inflation rates for the first time since 1955.

Though consumers have loosened their purse strings in recent months, deflationistas argue that if another financial crisis were to reduce credit availability, or if high ongoing unemployment once again begins to weigh on consumers' willingness and ability to spend, the threat of deflation could return. Those concerned about the possibility of a new round of deflation at some point keep an eye on consumer spending, the state of the credit and housing markets, and the stability of banks and other financial institutions.

Seeing shades of gray

Inflation and deflation aren't necessarily an either-or proposition. It's possible to have inflation in some areas and deflation in others; anyone who has watched food prices or health-care costs increase while their paycheck stayed the same and the value of their house declined can vouch for that.

From an investing standpoint, inflation isn't black-and-white, either. Some industries and asset classes benefit from inflationary forces, while companies that are highly dependent on both commodity prices and cheap labor can be more challenged by rising prices.

Getting an Early Start on Saving for Retirement

It's obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off your retirement savings. For example, if you retire at age 70 instead of age 65, and save an additional $22,000 per year at a hypothetical 6% rate of return, you can potentially add $124,016 to your retirement fund (and any existing savings will have five more years of potential growth). (This is a hypothetical example and not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Many people assume they can hold off saving for retirement and make up the difference later. But this can be a costly mistake. Waiting too long to start saving can make it very difficult to catch up, and only a few years can make a big difference in how much you'll accumulate. This doesn't mean there's no hope if you haven't set aside anything for retirement yet. It just makes it all the more important that you implement a plan today.

Start saving now

Start saving as much as you can, as soon as you can. The earlier you start, the longer compounding can work for you. For example, a 20 year old who saves $200 a month until age 65 and earns exactly 6% on saved funds annually would have accumulated around $550,000. But a 40 year old contributing the same amount each month at the same earnings rate would have accumulated only $138,600 by age 65.

Contribute $200/month to age 65 at different hypothetical earnings rates

	Start at age 20	Start at age 30	Start at age 40	Start at age 50
2%	$174,931	$121,510	$77,764	$41,943
4%	$301,894	$182,746	$102,826	$49,218
6%	$551,199	$284,942	$138,599	$58,164
8%	$1,054,908	$458,776	$190,205	$69,208

(This is a hypothetical example and is not intended to reflect the actual performance of any specific investment. Earnings are pretax, and may be subject to income tax when distributed.)

Take advantage of employer plans

Chances are your employer offers a 401(k), 403(b), or similar retirement savings plan. You can contribute up to $16,500 to a 401(k) plan in 2011. And if you're 50 years old or older, you can make additional "catch-up" contributions of up to $5,500, for a total of $22,000 in 2011.

Since pretax contributions are excluded from your paycheck, you'll enjoy an immediate tax savings when you contribute to one of these plans. For example, if your effective income tax rate is 30%, a $22,000 annual pretax contribution will only "cost" you $15,400 once the tax benefit is factored in. Of course, you'll have to pay income tax when you start receiving distributions from the plan, but it's possible you'll be in a lower tax bracket at that time (note that distributions made prior to age 59½ may be subject to a 10% additional penalty tax unless an exception applies). Your employer's plan may also allow you to make Roth contributions. There's no immediate tax benefit (contributions are made with after-tax dollars), but qualified distributions are entirely free from federal (and most states') income tax.

Even if you can't contribute the maximum allowed, you should at least try to contribute as much as necessary to get any matching contributions that your employer offers. This is essentially "free money." However, you may need to work up to six years before you're fully vested in (that is, before you fully own) any employer matching contributions.

Don't forget IRAs

You can contribute up to $5,000 to an IRA in 2011. You can also make catch-up contributions to an IRA if you're 50 or older--up to an additional $1,000 in 2011.

Your contributions to a traditional IRA may be deductible if neither you nor your spouse are covered by an employer retirement plan, or (if either of you are covered) your income falls within specified limits. Like pretax 401(k) contributions, deductible IRA contributions can result in an immediate tax savings, and as with 401(k) plans, withdrawals made prior to age 59½ may be subject to an additional 10% penalty tax unless an exception applies.

But even if you can't make deductible contributions to a traditional IRA, you can generally make nondeductible (after-tax) contributions. There are no up-front tax benefits, but your contributions will be tax free when withdrawn, and any earnings will grow tax deferred until distributed.

If your income is within prescribed limits, you can also make after-tax contributions to a Roth IRA. In this case, even the earnings are tax-free if your distribution is "qualified." Distributions are qualified if you satisfy a five-year holding requirement, and the distribution is made after you reach age 59½, become disabled, or die, or the funds are used to purchase your first home (up to $10,000 lifetime).

Make saving a priority

Saving even a little money can really add up if you do it consistently. Consider ways to free up more money to save for retirement--by reducing discretionary spending, for example. And, put retirement ahead of competing goals, even important goals like saving for your child's education.

Before investing in a mutual fund, you should carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. And don't forget that any investment involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

To produce a figure that indicates the value of the aggregated securities, an index divisor is typically applied to produce a more manageable figure that is easier to quote than the index's actual value.

All about Indices

No doubt you've seen headlines reporting that a particular index is up or down. But do you know how an index works, and why understanding the nuts and bolts of a specific index can make a difference to your portfolio?

An index is simply a way to measure and report the fluctuations of a securities market or a particular segment of a market. An index is developed by a company that sets specific criteria to determine which securities are included in the index--factors such as a company's size or location, or the liquidity of its stock. For example, the S&P 500 is a collection of large-cap U.S.-based companies that Standard and Poor's considers to be leading representatives of a cross section of industries.

The company that develops the index tracks the performance of its components and aggregates the data to produce a single figure that represents the index as a whole. Virtually every asset class has at least one index that tracks it, but because of the size and variety of the stock market, there are more stock indexes than any other type.

How indices are used

In addition to providing valuable information needed to monitor how a particular market is faring, an index can serve as the basis for mutual funds or exchange-traded funds that attempt to replicate its performance; that process is known as indexing. An index also can be used as a benchmark for funds that invest in the same asset class, regardless of whether a fund includes the same specific securities. Finally, some investment products do not attempt to replicate an index's performance but represent a bet on the index's general movements, though such investments can be challenging and are not appropriate for every investor.

You can't invest in an index

You cannot invest directly in an index. You could always purchase each and every security in the index and do the necessary trading to ensure that the portfolio continues to mirror the index, but the financial services industry has saved you the trouble. As noted above, investment products such as index mutual funds and exchange-traded funds are used by investors to try to capture a particular market's performance.

However, an index-based investment may not match the return of an index exactly. One reason is what's known as "tracking error." Costs such as taxes, operating expenses (even minimal ones), and transaction costs can differ among mutual funds. As a result, your return may be slightly different from that of the index or even other funds based on the same index, even though most index funds try to keep tracking error to a minimum.

Indices don't stay static

Though an index adheres to a set of guidelines for selection of the securities it includes, the company that oversees the index generally reviews the security selection periodically. For example, some indices are rebalanced if an individual security grows so large that it dominates the index. Others have a limit on how much of the index can be devoted to a particular sector or industry, and rebalance if the proportion gets skewed. And in some cases, an index is altered because of serious problems with one of its components (for example, Flowserve Corp. replaced Washington Mutual Inc. in the S&P 500 after WaMu was closed by the Office of Thrift Supervision in 2008).

Weight watching

Even indices that include the same securities may not operate in precisely the same way. Why? Because different indices may weight the relative importance of the same securities in different ways. The way an index is weighted determines how much of each individual security is included in it--for example, how many shares of stock. That weighting in turn can affect the overall index's performance.

Some indices are weighted based on market capitalization; the companies with the highest market cap (total value of stock outstanding) make up a larger share of the index than companies with a smaller market cap. As a result, those companies can have a disproportionate impact on the performance of an index weighted by market cap. For example, a 10% decline in the price of the largest company in the S&P 500 index would affect the index's overall return more dramatically than a 10% drop in the price of a much smaller company, because the S&P 500 is weighted by market cap.

Other indices are weighted by price; the most expensive stocks receive greater weight than lower-priced stocks. The Dow Jones Industrial Average, which includes 30 large, blue-chip industrial stocks and is commonly referred to as the Dow even though there are several Dow indices, is price-weighted. A relatively new approach to weighting an index is to use certain fundamental attributes, such as dividends or cash flow, as the basis for weighting the stocks that comprise the index.

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Can the IRS waive the 60-day IRA rollover deadline?

If you take a distribution from your IRA intending to make a 60-day rollover, but for some reason the funds don't get to the new IRA trustee in time, the tax impact can be devastating. In general, the rollover is invalid, the distribution becomes a taxable event, and you're treated as having made a regular, instead of a rollover, contribution to the new IRA. But all may not be lost. The 60-day requirement can be automatically waived in some cases, and the IRS has the discretion to waive the rule in others. The 60-day requirement is automatically waived if *all* of the following apply:

- The financial institution receives the funds on your behalf before the end of the 60-day rollover period
- You followed all the procedures set by the financial institution for depositing funds into an IRA within the 60-day period (including giving instructions to deposit the funds into an IRA)
- The funds are not deposited into an IRA within the 60-day rollover period solely because of an error on the part of the financial institution
- The funds are deposited within 1 year from the beginning of the 60-day rollover period
- It would have been a valid rollover if the financial institution had deposited the funds as instructed

If you don't qualify for an automatic waiver, you can apply to the IRS for a discretionary waiver. The IRS may waive the 60-day requirement where failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control. The IRS will consider all relevant facts and circumstances, including:

- Whether errors were made by the financial institution (in addition to those described under automatic waiver, above)
- Whether you were unable to complete the rollover on a timely basis due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error
- Whether you used the amount distributed
- How much time has passed since the date of distribution

What is the IRA one-rollover-per-year rule?

The one-rollover-per-year rule is a little known provision that says you can only make one rollover from a particular IRA to any other IRA in any 12-month period. A violation of the rule can have serious adverse tax consequences. Luckily, it's a problem that's very easy to avoid.

Here's how the IRS states the rule: "If you make a tax-free rollover of any part of a distribution from an IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over to an IRA."

This is best understood with an example. Assume you have three IRAs, A, B, and C. On January 1, 2011, you receive a distribution from IRA A and, within 60 days, you roll that distribution over to IRA B. The one-rollover-per-year rule says that any other distribution from IRA A that you receive before January 1, 2012, can't be rolled over. Similarly, any distribution from IRA B that you receive before January 1, 2012, can't be rolled over. You can, however, receive a distribution from IRA C and roll it over to any other IRA without restriction.

What happens if you violate the rule? The disallowed rollover is taxed as a distribution to you; if you're not age 59½, the additional 10% early distribution penalty may apply; you're treated as having made a regular, rather than rollover, contribution to the receiving IRA, so a 6% excess contribution penalty may apply; and you may be subject to additional penalties if you fail to report the "rollover" as a distribution on your income tax return.

So how do you avoid the problem? It's easy. Use direct transfers instead of 60-day rollovers. The rule doesn't apply when IRA funds are transferred directly from one trustee to another trustee (you never receive the funds). The rule also doesn't apply to conversions of traditional IRAs to Roth IRAs. So you can make as many trustee-to-trustee transfers, or Roth IRA conversions, as you like in any year--the one-rollover-per-year rule will not apply.