



FALL 2009



## trust & investment *perspectives*

### Is Inflation a Problem?

by Willard N. Woolbert



**R**enowned economist Milton Friedman famously said that “inflation is always and everywhere a monetary phenomenon”. Simply put, if there is more money available than goods to purchase, then prices must rise. Thus the massive stimulus that has come from the U.S. and other governments around the world in an effort to stabilize financial systems and restore growth has been viewed by many as a precursor to the next wave of inflation. The recent decline in the value of the dollar against other major currencies and gold’s breaching of \$1,000 per ounce provides anecdotal support for inflation’s return. Inflation is a critical factor for investors as changes in the level of inflation change the values of both stocks and bonds. Falling inflation, which we have generally experienced since the early 1980s, increases the value of cash to be received in the future, boosting values of stocks and bonds. Conversely, rising inflation would make bonds and stocks less valuable. As investors, should we be preparing for much higher inflation and if so, how do we do it?

Current data would suggest that we don’t have a problem. In August, the Consumer Price Index (CPI) was reported

to have declined at a 1.5% annual pace, although this number is distorted by the change in the price of energy. Oil last year at this time was just beginning to fall from \$150 per barrel. The Core CPI, a measure that excludes the volatile series for energy and food was 1.5%. Historically this is a very low figure, not indicative of inflationary problems.

Looking forward, there are two powerful economic indicators that also suggest that inflation will not be an issue in the coming year. Historically, inflation becomes a concern when the capacity of our manufacturing base is strained. The Federal Reserve produces a capacity utilization measure, which when trending above 80%, suggests that companies can

price their goods more aggressively. Currently, that measure of utilization is at 65%, the lowest since the statistic has been tracked. This suggests that due to lack of demand, companies have virtually no power to raise prices. The second significant input to inflation expectations is employment. Employment costs represent perhaps two thirds of the price of goods. As we know, the unemployment rate has risen significantly. Consensus estimates have employment continuing to fall into the early part of 2010. Along with falling employment, the change in compensation has been unusually restrained. Taken together, these series indicate that we are unlikely to see pressure on costs **continued on page 4**



### Frank Grebe’s Career Celebrated at Retirement Tribute

devotion to his clients. He will continue his association with Pennsylvania Trust in a consulting role.

Clients, colleagues and friends recently joined Frank Grebe (*far left*) in Pennsylvania Trust’s board room to reflect, with both respect and humor, on Frank’s 45 year career in the estate and financial planning industry. Frank was praised for his unfailing



## President's Message

I watched with great interest as world leaders met in Pittsburgh last month for the G-20 summit. The countries representing 85 percent of the world's economy were in attendance, a strong statement that the 21st century, indeed, heralds a global economy.

Many topics were on the G-20 agenda, but you can be certain the economy was at the top of the list, with spirited discussions on banking system reform, the role of central banks, and how to effectively stimulate global economic growth. Among other things, resolutions were made to create a stronger and more globally consistent regulatory framework for the financial sector with the intent of preventing further financial crises. This landmark gathering of world leaders bodes well for continued cooperation on matters of global economic policy as well as security and the environment.

At Pennsylvania Trust we have been widening our attention on global markets and emerging market countries. Many economists feel that developing markets will lead the economic recovery. China, in particular, is raising a great deal of interest as their economy continues to

strengthen, with projected growth of 9% to 10% for the upcoming year. Bill Woolbert touches on the upward trend of emerging economies in this issue of our newsletter where he also takes a closer look at inflation.

Closer to home, we note the first anniversary of the start of the financial crisis and breathe a collective but cautious sigh of relief that the economy seems to be stabilizing. Retail sales showed gains during August, suggesting that consumers are feeling more comfortable about spending. The recent rally in the equity market is another positive sign. Both residential and non-residential real estate continue to struggle and certainly employment figures need to stabilize, but the Federal Reserve is projecting 3% growth in the economy over the next 18 months.

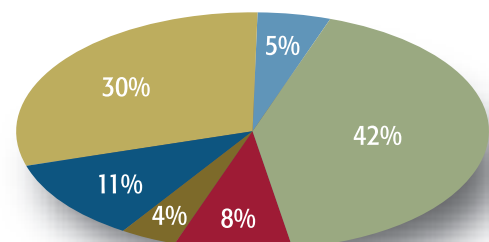
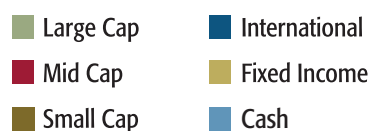
And so we are guardedly optimistic, ever mindful that the future most likely charts a very different path than previously seen. In a summary statement released by the G-20 group, one particular thought comes to mind, "A sense of normalcy should not lead to complacency." Much responsibility now lies with policymakers

who must wisely choose just the right measure of intervention to face a list of challenges that includes containing unemployment, rebalancing global spending, and stimulating growth.

In an Op Ed piece in *The Wall Street Journal*, Federal Reserve Board Governor Kevin Warsh suggests that those in the financial industry should assume the mindset of an athlete who has completed one leg of a triathlon. He says that this is "no time to declare victory and scarcely the moment to hand out medals. I cannot help but think of the strong but weary athlete who, after a morning swim, embarks upon a grueling cycling contest to a rising din of cheers and a smattering of boos – only to be reminded he is participating in a triathlon, and that he has a long run still before him." Our challenge remains finding prudent strategies that capitalize on market trends and opportunities in this new and global economy.

  
**Richardson T. Merriman**  
President and Chief Executive Officer

## Balanced Asset Allocation



# Converting a Traditional IRA to a Roth IRA May Offer Financial Benefits

by Irwin S. Love, Esq.



An upcoming change in the tax code will soon permit more individuals to qualify for converting a traditional IRA to a Roth IRA. Beginning in January of 2010, the limitation of \$100,000 of Modified Adjusted Gross Income (MAGI) has been eliminated. In addition, the restriction on married spouses filing separate returns will be eliminated.

Let's take a minute to review the basic benefits of a Roth IRA over a traditional IRA. First, qualified withdrawals from a Roth are not taxable income. And secondly, Roth IRAs require no minimum distribution (RMD) during the life of the owner.

There are a number of important points to consider before deciding if converting to a Roth IRA is best for you. On the downside, the conversion does involve paying income tax on the amount of pre-tax funds converted from a traditional IRA to a Roth IRA. However, with the depreciation in IRA portfolios seen during the recent financial downturn, many advisors see the present as an opportune time to convert. In fact, those with MAGI under \$100,000 might consider converting their traditional IRAs to Roth vehicles in 2009 not only because improved market conditions may increase their portfolios, but also because many analysts are suggesting that future tax rates may be higher.

Assuming 2010 is the right year for conversion for those who otherwise would be restricted by the limitations, the matter of paying income tax provides some choices for 2010 conversions only. If you convert during 2010, the income recog-

nized will be treated as occurring one half in 2011 and one half in 2012. Therefore, other than required estimated income tax payments, the tax will not be due on a 2010 conversion until April 15, 2012 for one half and April 15, 2013 for the other half. If you believe tax rates will increase for the years 2011 and 2012, you may opt out of the default treatment of income and elect to report it in 2010, the year you convert.

Another factor to consider is the number of years of tax-free compound growth available to the IRA owner, so as to balance out the income tax paid up front. In this scenario, individuals might be advised to consider a conversion well before retirement. The closer one gets to retirement, the less time you will have to recoup the tax and gain the benefit of compounding.

IRA owners should not look to their IRA as a source of payment for income tax on the conversion as this lessens the opportunity for long-term compounding of the amount converted. Also, if you have not reached 59½ years of age and use IRA funds to pay your tax, a 10% penalty is incurred. Further, once the Roth is funded, a requirement prohibits the withdrawal of funds within five years from the year of conversion or before age 59½.

A Roth conversion offers an excellent opportunity for tax-efficient wealth transfer for wealthy individuals who may not need to draw on the converted Roth for retirement income. As mentioned, there is no RMD at age 70½. However, while there is no RMD for an owner, upon

the death of the owner, individual beneficiaries must withdraw according to life expectancy tables. Naming grandchildren as beneficiaries provides the benefit of smaller yearly withdrawals over a longer life expectancy, magnifying the effects of compounding. As is the case for owners, beneficiary withdrawals are not taxable income. Thus, in paying tax up front, the IRA owner both reduces their estate for federal estate tax purposes while providing an ongoing stream of tax-free income to their heirs. (The Roth is considered an asset for federal estate tax purposes.)

Depending on the circumstances of each conversion, there are a number of possible twists to the ultimate result, including IRAs that have both pre-tax and after-tax contributions. Regardless of whether you convert one of many IRAs or a portion of one large IRA, you will need to prorate the total market value (MV) of after-tax contributions to the total MV of all of your IRAs to arrive at the percentage of taxable income for the conversion.

Another twist to be considered is the opportunity for re-characterization. The owner of a converted Roth that loses value after conversion can elect to re-characterize to a traditional IRA during the prescribed time limitation. This suggests that each conversion should be rolled to a separate Roth so the opportunity for re-characterization remains clear.

One should keep in mind that while the income limitations for **conversion** have been eliminated, the **funding** of a Roth is still governed by MAGI income limits, (\$120,000 for **continued on page 4**

**continued from page 1** for employers from labor for some time. This is confirmed by looking at unit labor costs which have been falling.

Both of these measures, while clearly supportive of a low-inflation scenario, are U.S. centric. Demand and cost pressures can come from outside the U.S. Very clearly, the emerging economies — particularly those of Asia — are recovering more quickly than the U.S. Demands on resources from these countries tend to be concentrated in basic resources and manufactured goods: energy, industrial metals, fertilizer, steel, and the like. These economies now represent over 30% of global GDP and their needs have an impact on the pricing of these basic inputs to their growth. Already in this recovery we have seen the price of oil move from \$35 to \$70 per barrel. Copper has moved from \$1.25 per pound to \$2.80. These are global prices, and while the U.S. demand may not support these prices, global demand does. These prices

will be reflected in our consumer price index, largely through energy pricing, but also in more subtle ways as higher input prices will move pricing in some industries.

A second source of inflation may be imbedded in the change in value of the U.S. dollar against the currencies of our trading partners. All else constant, a falling dollar makes the goods we import more expensive to us. Recently the dollar has fallen by 15% from an early March high. If, as the world recovers, the dollar's decline remains orderly, there should not be general pressure on prices. There may be industry-specific impacts, however. A falling dollar does make goods produced in the U.S. more competitive. Those industries or companies oriented towards the needs of the developing economies, may be able to use price more aggressively. A more abrupt dollar decline would have a more dramatic impact on prices and financial markets as well.

We do not see a general pressure on prices in the next year or two. What is

more likely is a commodity-driven pressure on prices. We saw this in 2007 and early 2008 and, although global growth is weaker now, it is likely to reappear in 2010. We are trying to take advantage of this trend in two ways. First, we focus portfolios on companies with an exposure to the developing economies. These companies should have the advantage of both a more rapid recovery in demand and a greater ability to use price as part of their earnings recovery. Second, direct investment in the developing economies through use of various funds provides the advantage of growth, but also provides exposure to currencies and markets that are direct beneficiaries of commodity inflation. Both offer us exposure to the most likely path for both growth and inflation.

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*Mr. Woolbert is Senior Vice President and Chief Investment Officer at Pennsylvania Trust.*

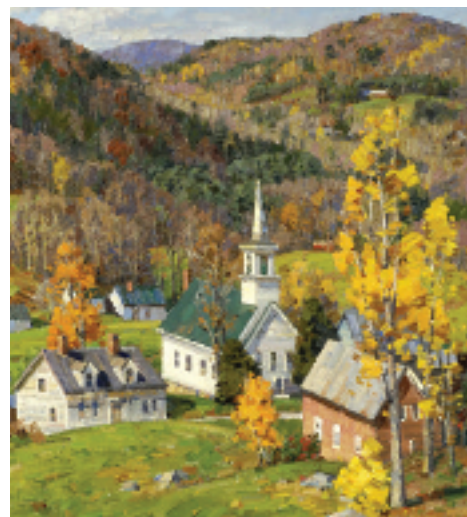
**continued from page 3** individuals and \$176,000 for joint filers). If you are currently over the Roth funding income limitation, you can still fund a traditional IRA with after-tax dollars in 2009 (\$6,000 for individuals over age 50) and convert to a Roth in 2010 under the relaxed guidelines.

It is important to understand the complexities of converting from a traditional IRA to a Roth IRA. There are many

factors to consider, including the direction of income tax rates, the ability to pay income tax without IRA funds, and the age and life expectancy of the IRA owner. Please consider enlisting the resources of a Pennsylvania Trust professional to help you evaluate if a Roth conversion suits your tax and financial planning needs.

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*Mr. Love is Senior Vice President and Chief Fiduciary Officer at Pennsylvania Trust.*



Thomas M. Nicholas, Autumn in Turnbridge, (detail)



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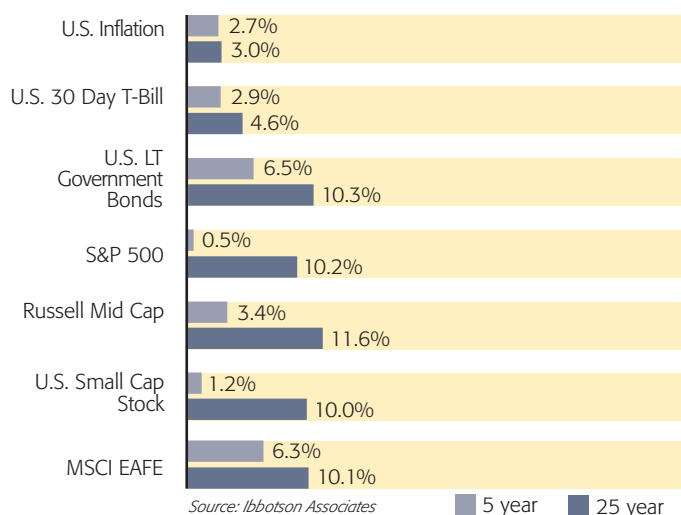
Pennsylvania Trust is committed to conduct all our relationships with integrity and to maintain the highest ethical standards; provide outstanding professional and personalized services; produce superior investment results consistent with client objectives; and retain exceptionally skilled individuals, empowering them with state-of-the-art technology.



# Market Indicators

	Current	Three Months Ago	One Year Ago
<b>Stock Indices</b>	9/30/09	6/30/09	9/30/08
Dow Jones Industrial Average	9,712	8,477	10,851
Standard & Poor's	1,057	919	1,166
<b>U.S. Treasury Yields</b>			
2 Year	0.9%	1.1%	2.0%
5 Year	2.3%	2.5%	3.0%
10 Year	3.3%	3.5%	3.8%
30 Year	4.1%	4.3%	4.3%

## ANNUALIZED RETURNS OF SELECT ASSET CLASSES



## CORE LARGE CAP DIVERSIFICATION

In order to maintain a well diversified large cap common stock portfolio, we recommend the following relative sector weightings within the Standard & Poor's 500:

S&P 500 Sector Weightings	Pennsylvania Trust	
Consumer Discretionary	9.2%	=
Consumer Staples	11.5%	-
Energy	11.7%	+
Financials	15.2%	=
Health Care	13.1%	-
Industrials	10.2%	=
Information Technology	18.7%	+
Materials	3.5%	=
Telecommunication Services	3.2%	=
Utilities	3.7%	=

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