Convert or Not to Convert? That is the Question

I have recently received a few questions regarding whether or not to convert a traditional IRA to a Roth. This question has several moving parts the most important of which are the assumptions going forward. Assumptions depend on your risk tolerance. So, an easy answer to this important question is whether you want to play it conservatively or aggressively.

If conservative, converting now is probably not a bad decision. Converting will require you to come up with funds to pay the tax bill from taking the distribution out of your traditional IRA. Paying the tax bill means you will presumably have to liquidate investments somewhere to have cash to stroke a check to the IRS. Here is where your risk tolerance becomes the driving factor.

Let's assume you are thinking of converting a $500,000 traditional IRA to a Roth. If you are in the combined Federal and State 25 percent tax bracket, you must come up with $125,000 cash. This is money you could have left in the stock market generating a return of 8-10 percent or more, depending on how you have allocated the money.

By liquidating an existing investment, you incur an opportunity cost or lost return. If you have to liquidate high returning stocks (high risk), you would be giving up the opportunity to achieve a high return. If you are liquidating a low returning investment (low risk), your opportunity cost is relatively low. Your risk tolerance is driving the bus.

There are, however, a few other less important factors to consider. If you think you will be in a lower tax bracket in retirement, paying the tax bill now does not make sense. If you think you will be in a higher bracket in retirement, paying the tax now makes sense. Investors 5 or 10 years ago who assumed tax rates would increase to cover large US deficits are now sorry they converted since tax rates have actually declined. Other investors made a similar assumption in 2008 when the stock market crashed. They paid a large tax bill to convert thinking the market would continue its torrid decline. This action resulted in an opportunity cost over the next 10-11 years as the stock market recorded one of its strongest return periods on record. My point is: don't guess the future economic landscape. It doesn't work.

A final factor is the tax-free distribution from a Roth 5 or more years later. This is an attractive feature and one that most analysts focus their attention. While important, the opportunity cost factor is more important.

Here is how I see the priority for deciding whether to convert or not:

- Priority 1: What is your opportunity cost? This is an unknown and can only be addressed by looking at your risk tolerance. An aggressive strategy suggests not converting while a conservative strategy suggests the opposite. Talk to JB or me if you need some help.

- Priority 2: What do you think your future tax bracket will be? Your answer depends on several factors with the most important being your life style in retirement. It is not unrealistic to assume a lower tax bracket even without legislative action, as some of us will slow down our spending in retirement. Again, talk to us about your plans. Everybody is different.

- Finally, where do you see the stock market headed? This is a trick question I should not ask because you can't nor can anyone else answer it with any accuracy.

That's it for now. All the best,,,,Ron