Spring 2009

In Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

THE LONG ROAD HOME

It has been a long road from December 2007 (the official start of the current recession according to the National Bureau of Economic Research). Since then, the news has not offered much comfort.

For many, questions about what will ultimately happen have combined with the fear that the economy may be too far gone to recover. Unfortunately, no one can say with certainty when we will emerge from this recession.

However, a better understanding of what is happening can go a long way toward providing a more balanced perspective. To that end, the following is a snapshot of the types of questions many investors have been asking.

1. How is the stimulus plan affecting the stock market?

There are many factors affecting stock prices. We cannot prudently point to any single factor as having primary influence over the stock market's decline. More importantly, although the stock market did not respond positively to the stimulus plan initially, this does not tell us what future returns will be. The stock market immediately incorporates all new information (good and bad) into prices, and where returns go from there is not dependent on whether the future is good or bad, but whether it is better or worse than expected.

2. Will we have high inflation?

Given all the monetary and fiscal stimulus, this is a significant risk. However, Federal Reserve Chairman Ben Bernanke is well aware of this. Bernanke does not want to repeat the mistake made by former Fed Chairman Alan Greenspan in 2003, when he allowed interest rates to remain low, despite the fact the economy was already recovering from the recession that began in March 2001.

When the economy eventually recovers, the Fed will likely begin removing the excess monetary stimulus to avoid future inflation. It could do this by selling Treasury debt — removing the excess liquidity and raising interest rates. Since we cannot know the future, one way to hedge this risk is to buy Treasury inflation-protected securities in tax-advantaged accounts as a portion of a fixed income portfolio.

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SHELF LIFE

"We find ourselves the richest and most powerful country on earth, but beset by all sorts of major problems and more apprehensive than confident of the future. Yet if we confine our attention to American investment experience … through all their vicissitudes and casualties, as earth-shaking as they were unforeseen, it remained true that sound investment principles produced generally sound results. We must act on the assumption that they will continue to do so."

— Benjamin Graham, *The Intelligent Investor*, Fourth Revised Edition, 1973

FIRST GIVE ME THE BAD NEWS

Whether by simple error or bias toward a better lead, the media may sometimes make bad news sound much worse than it already is. Case in point: The big Web headlines on various news sites on the morning of February 27, reporting the economy fell 6.2 percent in the fourth quarter.

This was such a blatant misrepresentation of the data released by the Department of Commerce that CNN took down its original banner headlines and updated the story to the correct statement: The economy fell in the fourth quarter at an ANNUAL rate of 6.2 percent. This means the economy shrank by about 1.5 percent in the quarter, not by 6.2 percent.

Another oversight: Information about gross domestic product (GDP) for the full year 2008 was also in the same Department of Commerce release. In 2008, real GDP increased 1.1 percent (from the 2007 annual level to the 2008 annual level). In 2007, real GDP increased 2.0 percent. No mention of this was made in the CNN.com story.

The point is, while recent news has been very bad indeed, perhaps it is not quite as bad as the media reports. We need to recognize this as we continue to make our way through tough economic times.

UNDERSTANDING ASSET LOCATION

By Dr. William Reichenstein

This article discusses asset location, which is one of the most important portfolio design considerations, second only to asset allocation. Asset allocation is the process of deciding how to allocate assets among stocks, bonds and cash. Asset location is most often about determining which holdings are best held in tax-sheltered versus taxable accounts.

In this example, Jessica has $500,000 in a Roth IRA and $500,000 in a taxable account. She wants an asset allocation of 50 percent fixed income and 50 percent equities. She could split both her Roth IRA and taxable account into half fixed income and half equities. But with today's tax rates, a better asset-location strategy may be to hold fixed income in the Roth IRA and hold equities in the taxable account. To understand why this strategy may be better, consider the explanation below.

Most investors pay higher tax rates on ordinary income than on qualified dividends and long-term capital gains. Let's assume Jessica pays federal taxes at 25 percent on ordinary income from fixed income interest and at 15 percent from equities' qualified dividends and net long-term capital gains. The qualified dividends and net realized long-term capital gains held in taxable accounts are taxed at 15 percent. However, the fixed income interest held in taxable accounts is taxed at 25 percent. Obviously, the 15 percent tax rate is preferable to the 25 percent tax rate.

Equity and fixed income returns earned in a 401(k) or tax-deferred annuity are eventually taxed as ordinary income. In essence, the investor has converted capital gains from equity appreciation into ordinary income when distributions are made.

When equity prices fall, Jessica can realize the losses and let the government share in the losses by using them to offset current and future capital gains. In addition, to the extent that losses exceed gains in any given tax year, up to $3,000 per year of losses can be used to offset ordinary income. In contrast, the government does not share in losses on assets held in Roth IRAs or 401(k)s.

In short, equities' capital gains and qualified dividends receive preferential tax treatment when held in taxable accounts. Equity returns do not receive preferential treatment on assets held in retirement accounts. Thus, as investors strive to achieve their target asset allocation, strong consideration should be given to strategically locating equities in taxable accounts and fixed income in retirement accounts whenever possible.

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3. Is it wise to move to cash now and get back in after the recession is over?

This is not a wise strategy. Investors who move to cash should be prepared to stay there. Here's why: Most of the market's returns happen over very short and unpredictable periods, and the market typically recovers well ahead of the economy. Studies on individual investors have found that investors end up with bond-like returns while taking equity risks because they are constantly jumping in and out of the market.

More prudent strategies for investors to follow would be to stick with their current asset allocation and rebalance (because their plan should have been built to anticipate bear markets), or lower their equity allocation because they realize they took more risk than they should have. An overall goal for investors is to find an asset allocation that allows them to sleep well at night while still making it possible for them to achieve their goals.

4. Would lowering one's equity allocation automatically mean having to give up one's most important goals?

Investors who decide to lower their equity allocation might be concerned about still being able to achieve their financial goals. Sometimes, investors identify a set of goals and define all of them as needs.

Upon revisiting their plan, investors may find certain goals originally classified as needs that no longer qualify as such. Moreover, it can be encouraging to recall that many personal goals and an individual's general happiness may have little connection to the achievement of financial goals.

Investors who discover outdated goals driving their asset allocation should update their plan accordingly. ❖

MAKING PLANS

Four Vehicles to Consider When Planning a Charitable Estate
Each of these vehicles has the potential to reduce your overall estate tax liability.

Charitable remainder trust. You can use the donated assets to pay income to yourself or your heirs for a set period (often for life). At the end of that period, assets in the trust will be distributed to the designated charity. Contributions to the trust are tax deductible in the year of funding and removed from your taxable estate, and you avoid capital gains tax if transferred assets are sold by the trust. This is a particularly useful vehicle for highly appreciated property.

Charitable lead trust. The trust assets provide income to a charity for a specific period. At the end of that period, your trustee will disburse the remaining assets to the noncharitable beneficiaries. The assets are passed to your heirs as a gift at the present value of the asset at the term's end. Capital gains tax can be avoided up to prescribed amounts each year. Contributions to the trust are tax deductible in the year of funding.

Donor-advised fund. A donor-advised fund is an alternative to a private foundation. Financial services firms or community foundations typically assume responsibility for administering a fund's charitable assets. Contributions to the fund are tax deductible in the year of funding. Many funds have online capabilities to further simplify charitable giving.

Irrevocable life insurance trust (ILIT). You can establish an ILIT and gift annual premiums to the trust, and the trustee can purchase a life insurance policy on you. After your death, the life insurance proceeds are paid to the ILIT without being included in your estate. The trustee manages or distributes the proceeds to beneficiaries in accordance with the terms of the ILIT.