IN THIS ISSUE

Trust UPDATE

Stillman BANK

Asset allocation—*What's that?*

For investors, these are indeed interesting times.

The news for investors generally has been hard to digest.

- Stock market indices repeatedly have made new highs this year, suggesting that the economy is on a steady, if slow, positive course. By traditional measures, such as price/earnings ratios, stocks are starting to look expensive.
- But interest rates are at sustained lows, because the Fed has considered the recovery too weak to withstand a rate increase. What's more, when interest rates eventually do move up, bondholders will experience paper losses, because bond prices move in the opposite direction of interest rates.
- The Fed has indicated that its bond purchases will be phased out by October. If they make good on this promise, the effect that this will have on the economy and the markets is uncertain. It is possible that the apparent current strength of the stock markets comes not from expectations of prosperity but from a greater fear of the bond markets.

What should investors do when nothing looks appealing? Sitting out the game is not an option. What every investor should have is a plan, one that looks beyond the short term to the probability of being ready for the next change in the market cycles.

One answer: Asset allocation

An asset allocation plan is an "all-weather" investment approach. To oversimplify, there are four steps:

Step One. Determine the expected returns in up and down markets for every asset category, most broadly for stocks, bonds and cash. Generally, the asset classes will be more finely divided—for example, government versus corporate bonds, large stocks versus small stocks, foreign stocks versus domestic stocks, sector stocks, and so on.

Step Two. Calculate the correlations of the asset classes. Assets do not move up and down in lockstep. When stocks rise, bonds may fall. Or at other times, bonds may also rise when stocks do. Some sectors will do better when the economy is growing; others may thrive in adversity. The movements of each asset class over time can be correlated to every other asset class.

Step Three. Decide which combination of these asset classes offers the best expected return for a given level of investment risk. Alternatively, for a given return target, find the combination of asset classes offering the lowest expected risk. This process is sometimes called portfolio optimization.

Step Four. Given the target allocations for the portfolio, select investments within each class.

Choose the proper time horizon

Expected returns need to be linked to the investor's time horizon. Longer time horizons give the investor more time to recover from bad years, more chances to be in the market for good years. (See "Stocks, Bonds and Cash—Looking longer term" for the historical five- and ten-year returns.)

Recently, a couple in their late 50s came to us for some portfolio advice. They were planning to retire in five years, and so were expected to move their money out of stocks and into bonds as their retirement date approached.

This couple had confused their retirement horizon with their investment horizon. The fact is, their retirement is likely to last for at least 20 years, so their investment horizon should be that much or more. That amount of time eases the risks of stock market investing—and increases the chance that investors will run into a period of inflation. Although some portfolio adjustments were appropriate, they were far less dramatic than the couple had anticipated.

Some investors have more than one time horizon. For example, 45-year-old parents have a long time horizon as far as their own needs are concerned. But what about college funds that they have established for their teenaged children?

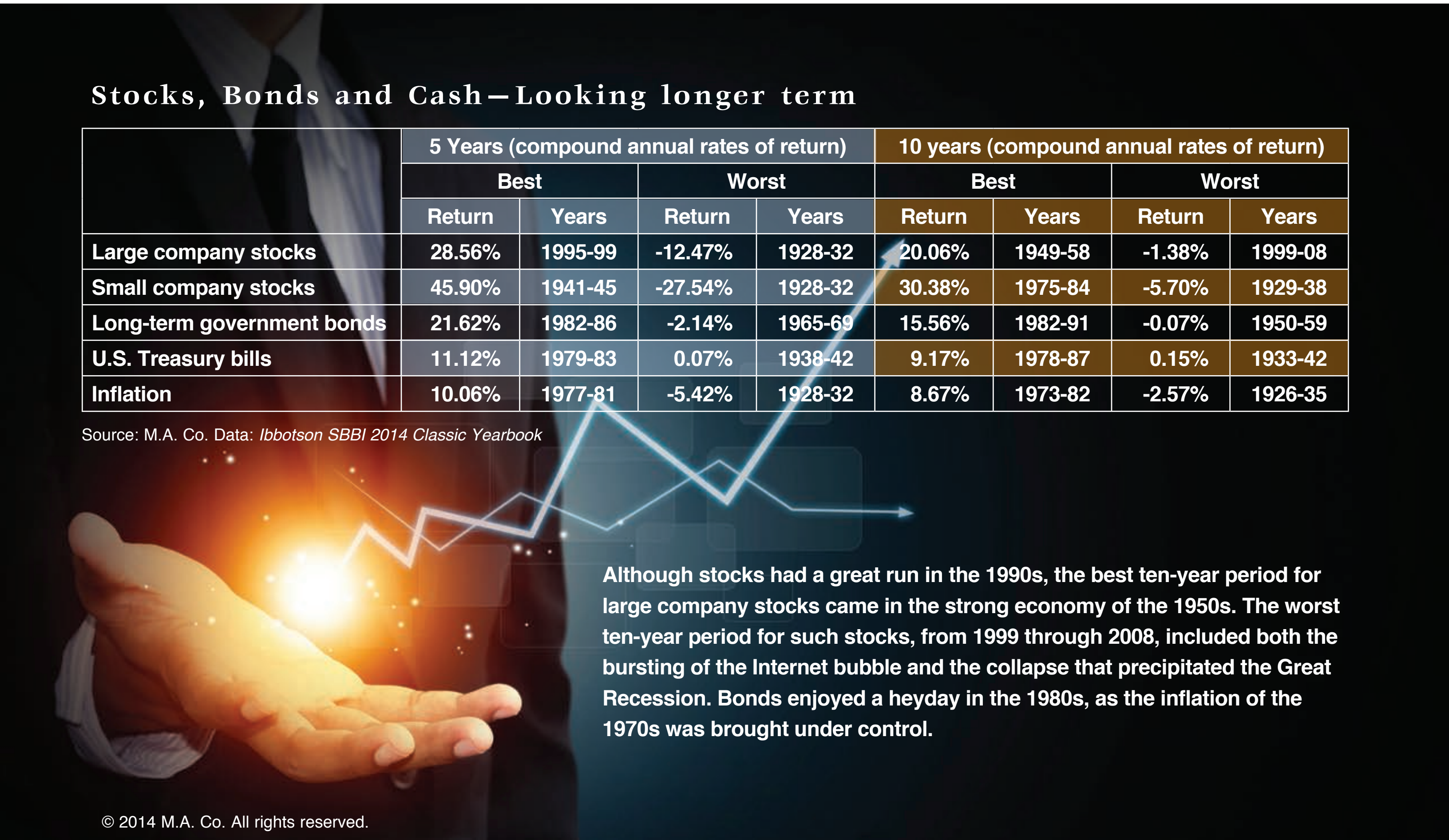
Let us help you

We have a variety of individually tailored investment services to meet the needs of our clients. These include:

Investment management. We'll help you identify your goals and develop an asset allocation plan suited for your time horizon and risk profile. Then we'll create a diversified portfolio, including stocks, bonds and cash, that is consistent with your objectives, income needs and risk tolerance. You'll receive regular progress reports.

Revocable living trust. A trust is similar to an investment management account, with pluses. Plus full financial management in the event of your incapacity. Plus probate avoidance. Plus protection of your beneficiaries beyond your lifetime.

Our aim is to provide that quantity of service with which each client is most comfortable, which best meets each client's needs. For more information on our investment planning and management capabilities, please arrange to speak with one of our asset management specialists. ☐



Stocks, Bonds and Cash—Looking longer term

	5 Years (compound annual rates of return)				10 years (compound annual rates of return)			
	Best		Worst		Best		Worst	
	Return	Years	Return	Years	Return	Years	Return	Years
Large company stocks	28.56%	1995-99	-12.47%	1928-32	20.06%	1949-58	-1.38%	1999-08
Small company stocks	45.90%	1941-45	-27.54%	1928-32	30.38%	1975-84	-5.70%	1929-38
Long-term government bonds	21.62%	1982-86	-2.14%	1965-69	15.56%	1982-91	-0.07%	1950-59
U.S. Treasury bills	11.12%	1979-83	0.07%	1938-42	9.17%	1978-87	0.15%	1933-42
Inflation	10.06%	1977-81	-5.42%	1928-32	8.67%	1973-82	-2.57%	1926-35

Source: M.A. Co. Data: *Ibbotson SBBI 2014 Classic Yearbook*

Although stocks had a great run in the 1990s, the best ten-year period for large company stocks came in the strong economy of the 1950s. The worst ten-year period for such stocks, from 1999 through 2008, included both the bursting of the Internet bubble and the collapse that precipitated the Great Recession. Bonds enjoyed a heyday in the 1980s, as the inflation of the 1970s was brought under control.

Estate plan rewrite

The names are fictitious, but this story is based upon an actual recent IRS private letter ruling.

Oliver's will created a Qualified Terminable Interest Property trust (QTIP trust) for his surviving wife, Lisa. This trust pays all of its income to Lisa for the rest of her life, and the trust assets pass to their children at her death. The QTIP trust is very standard estate planning these days, especially in the case of blended families.

However, the QTIP trust was not delivering the financial protection that this family wanted. First, the children were impatient for the inheritance, and they needed assets now. The second problem went to the definition of "trust income." Traditionally, trust income consists of interest and dividends, as trust assets include stocks, bonds and mutual fund shares. Traditionally, capital gains are credited to principal, not income. The current financial markets, with sustained ultra-low interest rates and modest dividend yields (many stocks pay no dividends at all), can make it difficult to wring an adequate income from even a large portfolio.

Traditional income versus total return

Trust value	Interest rate	Dividend rate	Capital gain	Traditional income	5% total return distribution
$1,000,000	0.75%	2.0%	6.0%	$27,500	$54,375
$1,000,000	2.0%	1.5%	-5.0%	$35,000	$49,250

Source: M.A. Co. Returns are for illustration only and do not represent any specific investment.

During periods of low interest rates and rising stock market values, a total return approach to income distributions can result in markedly higher payouts to income beneficiaries. On the other hand, when stock prices are in decline, the total return approach may deplete the trust assets more quickly.

A three-trust solution

Lisa's financial and estate advisors recommended dividing the trust into three successor trusts:

- a new QTIP trust, identical in every way to the original trust;
- a "total return" unitrust for Lisa; and
- a trust for the children, which would be terminated immediately to provide them with an advance on their inheritance.

There are several tax wrinkles to be concerned about. The purpose of allowing the marital deduction for a QTIP trust is to defer the federal estate tax until the death of the surviving spouse. If the trust, or portion of the trust, terminates before the spouse dies, a gift tax will be due. So it was in this situation, Lisa is making a gift of a portion of her income interest and the actual value of a portion of the remainder, and that amount is subject to federal gift tax.

However, the advisors added a feature to the plan that helped to bring down the gift tax owed. The heirs agreed in writing that they would pay any gift tax due to the IRS. That agreement creates a "net gift"; that is, the taxable value of the gift is reduced to the amount left after paying the gift tax. The math can be complicated, as a series of computations are needed.

Lisa also wanted to make certain that the arrangement would not trigger taxes on the new QTIP or the total return trust, and the news from the IRS was favorable on that score.

A new definition of income

The income distribution from a total return unitrust is not determined by reference to credited interest and dividend payments. Rather, it is stated as a percentage of the value of the trust's assets, determined once each year. The unitrust rate is typically from 3% to 5%, a range that historically has not led to the depletion of the trust assets. With this approach, the trustee may invest for greater capital gains without being concerned that the income beneficiary is being put at a disadvantage.

Lisa lived in a state in which the trust laws expressly allowed for total return trusts and the creation of new trusts with the consent of all the trust beneficiaries. See your advisors to learn more if this sort of planning appeals to you. ☐

FATCA shifts to high gear

Problem: Too many American taxpayers are hiding their assets outside the country in order to evade their tax obligations. Solution: The Foreign Account Tax Compliance Act (FATCA), enacted with little fanfare in 2010 as part of the Hiring Incentives to Restore Employment Act. The main provisions of the legislation went into effect last July 1.

Under the bill, certain U.S. taxpayers who hold foreign financial assets with an aggregate value of $50,000 must report that information on a newly created Form 8938. They also may need to file a Foreign Bank Account Report (FBAR) if such assets total more than $10,000 at any time during the year. Failure to report may lead to a penalty of $10,000, and underpayments of tax attributable to nondisclosure may trigger an understatement penalty of 40%. Tough medicine.

Foreign financial institutions are required to report to the IRS information about accounts owned by U.S. taxpayers. "Participating" institutions will have to file reports on U.S. account holders annually. *The Wall Street Journal* reports that 77,000 foreign banks have agreed to participate in the program. However, some foreign banks reportedly are refusing to open new accounts for Americans, because of the high paperwork costs. Others have raised account minimums to the $1 million level.

Offshore Voluntary Disclosure Program

The high penalties are the stick, but the IRS also offers a carrot, the Offshore Voluntary Disclosure Program. Taxpayers who take the initiative to start reporting their foreign accounts, instead of waiting to get caught, may avoid criminal prosecution and face lower penalties. To date more than 45,000 taxpayers have come forward. They've paid about $6.5 billion in taxes, interest and penalties.

In June the IRS announced that, effective July 1, taxpayers may come into compliance by:

- filing amended or delinquent tax returns for the prior three years;
- certifying that the failure to file and report all income was not willful;
- paying all taxes and interest owed; and
- filing delinquent FBARs for the prior six years.

Under this program, nonresident taxpayers won't have to pay a penalty if they lived outside the U.S. for at least 330 days in the prior three years. U.S. residents will have to pay a penalty of 5% of the highest aggregate value of their unreported foreign financial assets during the prior three years.

How does one certify that the failure to include foreign assets on a tax return was not willful? By stating that there was a misunderstanding of the law, inadvertence or even negligence in preparing the tax returns. ☐