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Trust UPDATE

Investing in an environment of low interest rates

Where do the markets go from here?

The current extended period of low interest rates, begun in December 2008 to combat the severe recession, has affected savers and retirees adversely. Many have had to dip into principal to meet ordinary expenses. Most market observers expected that interest rates would begin to move up in 2014, but that did not happen. The Fed has suggested that an interest rate increase is very likely to occur later this year, now that its program of quantitative easing has ended. Ironically, European central banks are now poised to begin their own programs of quantitative easing to break out of a sluggish growth pattern and respond to deflationary fears in Europe.

How long can near-zero short-term interest rates continue? The graph on page 2 from the St. Louis Federal Reserve Bank compares the short-term T-bill rates with intermediate-term 10-year bonds; recessions are marked in gray. As the long and short rates approach each other, the yield curve flattens, a harbinger of another recession. A widening spread generally predicts an improving economy, and that's what the graph shows today. As the economy improves, interest rates should have room to rise.

If that happens, CD investors will welcome an increase in the rates that they get. But what will a jump in interest rates mean for your investment portfolio?

Stocks

According to conventional investment theory, stock investors are seeking a premium over the "riskless" rate of return, which is represented by short-term Treasury bills. That premium compensates them for the additional risk inherent in equity investing. An increase in interest rates means an increase in the riskless rate of return, which, in turn, raises the hurdle that stocks must beat to remain attractive. In other words, in normal times higher interest rates are bad for stock prices, because they increase the relative attractiveness of bonds.

These may not be normal times, however. The riskless rate of return is nearly zero at the moment. An increase in interest rates from this level may be interpreted by investors as a sign of economic health and, therefore, be a buying signal. In that event, stock indices might rise.

Bonds

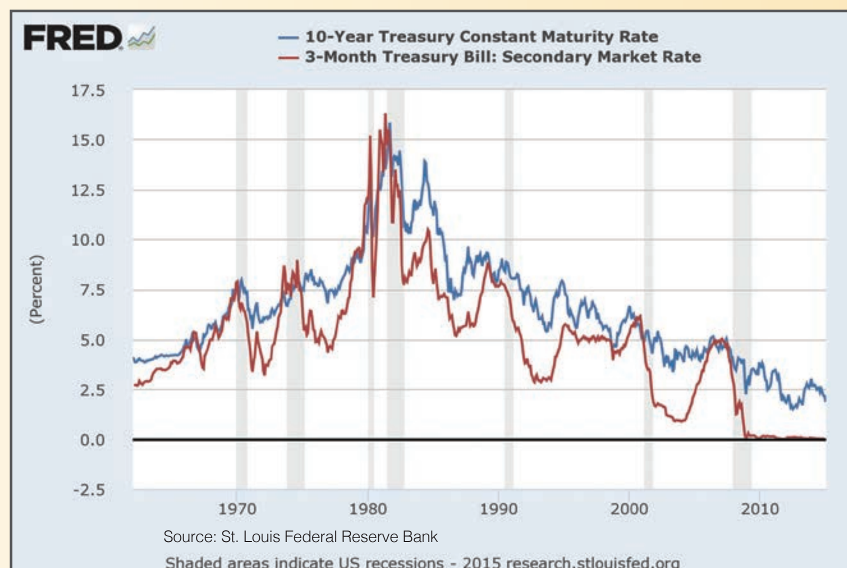
Rising interest rates are not the bondholder's friend, of course. As interest rates rise, the price of outstanding bonds must fall. The opportunity to reinvest funds at higher rates may be welcome, but there may be paper losses on the longer-term maturities.

Still, bonds play an essential role in a balanced investment portfolio. They may damp down the overall volatility, and they offer a steady stream of income to meet cash requirements or for reinvestment. In times of economic uncertainty, one often sees a "flight to quality," which may explain the resilience of the market for U.S. government debt in 2014.

There is also a strong temptation to park assets in the relative safety of money market funds, waiting for a better time to invest. That's not often the best approach. The problem is successfully identifying that better time to invest—uncertainty is inher-

The astonishing long-term decline in interest rates

Interest rates were on a fairly persistent upward path through the 1960s and 1970s, as shown in this graph from the St. Louis Federal Reserve Bank of the rates for 10-year Treasury bonds. The rate peaked at over 15% early in the Reagan presidency, when the Federal Reserve Board took strong anti-inflation measures. Since then, interest rates have declined, and remain at historically low levels. Rates tend to fall during recessions, as the Fed lowers short-term interest rates to stimulate the economy. Since the 1980s, rates have not bounced back as the economy expands. Many observers expected that to change in 2014, but they were proved wrong.



ent in the financial markets.

Investors use the measurement of *bond duration* to approximate the sensitivity of a bond, or a group of bonds, to interest rate changes. If an intermediate-term bond has a duration of 7, for example, a one-point increase in interest rates will cause a 7% decrease in the value of the bond. A bond fund with an average duration of 5 will drop in value by 5% if interest rates rise by one point, or it will gain 5% should interest rates fall by that amount.

When rates are low, there is a powerful temptation to mitigate interest rate risk by shortening the maturity of the bond portfolio. But at the current very low rates, that approach means bringing the yield down to a level most investors find unacceptable. There are alternatives to consider.

- ***Barbells.*** Simply to increase the yield from a bond portfolio, long- and short-term bonds may be acquired, avoiding the intermediate maturities. If the long-term bonds can be held to maturity, the investor need not worry about paper losses that occur if interest rates rise. Meanwhile, the short-term bonds can be reinvested at higher rates as they mature.
- ***Ladders.*** Building a laddered portfolio involves buying an assortment of bonds with maturities distributed over time. For example, you might invest equal amounts in securities maturing in two, four, six, eight and ten years. In two years, when the first bonds mature, you would reinvest the principal in a ten-year bond, maintaining the ladder. This approach provides better protection against interest rate risk than investing in a bond with a single maturity, especially a longer maturity. The ladder generally provides a greater yield than investing only in short-term issues.
- ***Riskier bonds***. All bonds are not created equal. Corporate bonds usually offer higher yields, to compensate investors for the somewhat larger chance of default. Municipal bonds add the element of freedom from federal income taxes for interest payments.

A capsule guide to our services for investors

Our services are, in essence, powerful financial planning tools built upon important investment management components. One of the great strengths of trust planning is the ability to tailor the plan to respond flexibly to current and future financial needs.

Portfolio supervision. Serious investing is a full-time job. Our investment advisory and investment management services put experienced investment professionals on your side. The officer assigned to your account will work with you to establish an investment strategy suited to your personal goals and circumstances. Asset allocation planning will be employed to optimize your portfolio, reducing investment risk through a process of disciplined diversification.

Lifetime financial management. The next step in comprehensive financial protection employs a *revocable living trust*. We begin by developing an investment policy for the trust based upon your requirements. We will implement that plan, providing continuous portfolio supervision and distributing or reinvesting trust income as directed. As trustee, we can move beyond the investment sphere, arranging to pay household bills and taxes on your behalf. A revocable trust provides financial protection in the event of incapacity, and it has important estate planning advantages as well.

IRA rollovers. Anyone who will receive a lump sum distribution from an employer's retirement plan would be well advised to take a careful look at an IRA rollover for the funds. A rollover preserves valuable tax privileges and can enhance your retirement capital. Taxable withdrawals may begin without penalty at age 59½, and a program of minimum withdrawals must begin at age 70½. With their tax-deferred nature, IRA rollovers present somewhat unusual investment issues, which should be resolved in the context of a full review of financial resources.

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Let us help you

Even though the Fed has been steadfast in its commitment to return interest rates slowly to normal ranges, outside events could alter that course. No one was predicting that oil prices could fall so low quickly, and the full economic effects of that are not known. Lower oil prices reduce inflationary cost pressures, and could free up more consumer spending in other areas of the economy. On the other hand, the oil industry will be adversely affected, as well as employment in this crucial sector. Similarly, foreign events have a way of intruding upon our economic expectations.

How does one do financial management in an era of uncertainty? Finding good help for investment management is no easy matter. It's a bit like selecting a doctor or a lawyer. You have to find someone you can trust, someone with whom you feel comfortable.

That someone should be us. We offer unbiased investment advice, designed with the needs of you and your family in mind. We utilize a team approach to investment and financial management, with professionals from a range of disciplines to provide you with a complete financial management solution.

If you haven't yet taken advantage of our services for investors, we invite you to make an early appointment to learn more about our offerings. ☐

Taxpayers are allowed to make one tax-free IRA rollover per year. IRS Publication 590 stated that the rule applies per IRA. An example will make this clear. Assume that a taxpayer owns IRA 1 and IRA 2. He takes a distribution from IRA 1 and rolls it into IRA 3. According to Publication 590, taxpayer is not permitted another tax-free rollover from either IRA 1 or IRA 3 for one year. However, the taxpayer *is* permitted to roll a distribution from IRA 2 into IRA 3.

As it turns out, Publication 590 was wrong. The Tax Court last year decided that the clear language of the statute applies on a per taxpayer basis, not a per IRA basis. The issue came up when a couple tried to tack a series of IRA rollovers together to create a six-month loan for themselves. Husband withdrew $65,064 from his traditional IRA on April 14, 2008, and another $65,064 from his rollover IRA on June 6, 2008. On June 10, 2008, $65,064 was returned to the traditional IRA. Wife withdrew $65,064 from her IRA on July 31, 2008. On August 4, within 60 days of the husband's June 6 withdrawal, the $65,064 was redeposited in the rollover IRA. Wife made a partial redeposit of $40,000 to her IRA on September 30. The couple treated all of these transactions as nontaxable rollovers, and they reported no taxable IRA distributions.

The plan failed on several fronts, according to the Tax Court. Although the couple assumed that the rollover restrictions apply on a per account basis, instead they apply per taxpayer. The tax code is not ambiguous on the question. So only Husband's first rollover was tax free; the second was not. Wife is entitled to her own rollover, but here the mistake was more prosaic. One might assume that September 30 is within 60 days of July 31, but it is not. In fact, that is the 61st day, so Wife's partial redeposit did not reduce the taxes on her withdrawal either. These were premature distributions, subject to the 10% penalty tax. Failure to report the distributions as taxable led to a significant understatement of tax liability, triggering another 20% penalty. All in all, perhaps the "short-term loan" from the IRAs wasn't such a good idea.

IRS response

The IRS acknowledged in an announcement the error in Publication 590 and in the Regulations. Changes were made, consistent with the Court's ruling. However, the changes are only taking effect now, for IRA rollovers that occur in 2015.

New guidance provides that IRAs and Roth IRAs will be lumped together for this purpose. Note that this is not a once-per-tax year rule, a full 12 months must elapse between IRA rollovers, whether traditional or Roth IRAs. Note also that a conversion of a traditional IRA to a Roth IRA is not considered a rollover at all.

The penalties for running afoul of this rule can be severe, including taxation and penalties on the rollover amount, possible disqualification of the tax deferral for the IRA, and imposition of a 6% excess contribution penalty on amounts rolled into the successor IRA. Penalties for reporting failures could be triggered also.

The better way

Taxpayers do have a much better alternative for moving money among IRAs. A trustee-to-trustee transfer is not considered a "rollover" at all, even though it accomplishes the same thing. The 60-day rule and the once-a-year rule only are triggered if the IRA owner receives a check as part of the process. What if a taxpayer receives a check made out to the successor trustee? The IRS recently clarified that this circumstance also won't be considered a rollover, because the taxpayer never has temporary access to the funds. ☐

A new voice for repealing the federal estate tax

Just as President Obama asks for increasing taxes on inheritances, there could be a move in the opposite direction in Congress. Rep. Kristi Noem (R-S.D.), a member of the House Ways and Means Committee, has first-hand experience with the estate tax. When her father died in a farming accident in 1992, she had to leave college to return home to help run the family ranch. The family had no money in the bank but lots of land, machinery and cattle. "All of a sudden, I owed the federal government hundreds of thousands of dollars because a tragedy happened. That's unfair," Noem has said.

Although today's $5.43 million federal exemption provides better protection than her family experienced in 1992, it's not enough to protect most family agricultural operations, according to Noem. She favors complete estate tax repeal and was a co-sponsor of the "Death Tax Repeal Act of 2013." "As a lifelong farmer and rancher, I will be a strong voice for the agriculture industry on the panel," she said.

How to fix a drafting mistake

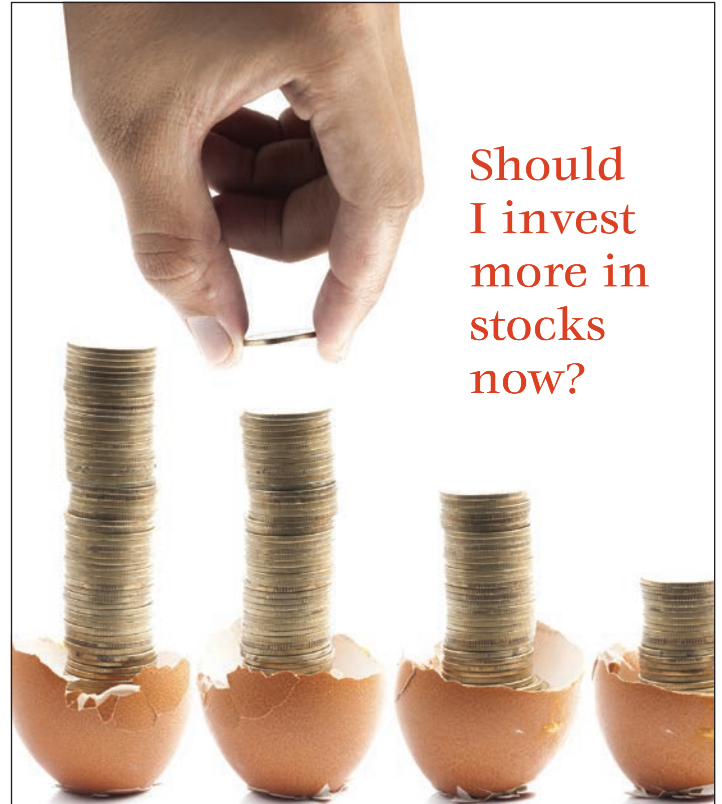
At his death, Grantor's revocable trust became irrevocable, providing life income for his mother and another beneficiary, with the remainder passing to charity. As such, the trust does not qualify for an estate tax charitable deduction. Within 90 days of the date that the estate tax was due, the estate's executor sought a reformation of the trust, transforming it to a charitable remainder unitrust, in order to secure the deduction.

The IRS agrees that this will work. The original trust included a "reformable interest" that was ascertainable and severable from the noncharitable interests. It would have qualified for the charitable deduction before enactment of tighter rules on drafting charitable trusts decades ago. Furthermore, on the facts presented, the value of the qualified interest will be within 5% of the reformable interest.

Noteworthy

"For those who like their tax rhetoric served with a side order of irony, here's a tasty one: In his State of The Union Address tonight President Obama will propose closing what the White House has dubbed the "trust fund loophole." But the loophole Obama is aiming at has nothing to do with trusts and closing it could actually increase the tax appeal of trusts."

—Janet Novack, *Forbes*, 1/20/2015



Sound investment management isn't about simply maximum return and minimum risk. It's a question of balance, weighing short- and long-term objectives, tax profiles and risk tolerances. That's a process that must begin with an intimate financial understanding of each individual client.

That's our kind of investment management service, one built on planning, not timing. Come talk with us this month to learn more.

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