IN THIS ISSUE

Investment planning

Portfolio risk assessment
Five years of returns of stocks, bonds and cash
What we bring to the table

Retirement planning

The "no inflation" blues

Living trusts

Which trust would you choose?

Trust UPDATE

Portfolio risk assessment

One approach to understanding investing risk is to array categories of investments in a pyramid. At the base one find's the safest investments—savings accounts, certificates of deposit, money market funds. The next layer, which might include blue-chip stocks, Treasury bonds and municipal bonds, is somewhat riskier. Then comes a layer with corporate bonds, growth stocks and rental real estate. At the top of the pyramid, with the greatest risks, are junk bonds, speculative stocks and options trading.

Actually, it's not that simple. As researchers learn more about investment risk, some have found two shortcomings in the pyramid concept:

- For short-term investors, the pyramid probably understates risk.
- For long-term investors, it may misstate the risk of various investment classes.

Why should these shortcomings concern you? Unless you see risks clearly, you can't make an accurate risk assessment for your own investment program.

Risks in the short term

For short-term investors—people who will need to sell in a few years—even blue-chip stocks are more than slightly risky. So are long-term bonds, even Treasury bonds. Here's why:

- Stock prices can plummet 20%, 30% or more in the course of a year. They fell 38% in 2008. The Standard & Poor's 500-stock index measures the performance of shares in 500 major, large capitalization companies. By that measure, stocks produced annual losses, even with dividends reinvested, four times in the last 15 years. As the table below shows, for one-year holding periods, stocks have been in the red about 27% of the time.
- Long-term bonds also can be surprisingly risky for investors with relatively short time horizons, such as one who may have to sell the bond before maturity. As interest rates rise, the value of an existing bond must fall. In 2009, for example, long-term government bonds had a total return of –14.9%. Bonds have been in the red for 26% of one-year holding periods since 1926.

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Time tempers returns

Over the past 89 years, stocks and bonds have had positive years about three-quarters of the time. Longer time horizons have yielded positive results more frequently. This table shows how often three portfolios have had positive returns for various holding periods.

Holding periods	100% stocks (times positive)	50% stocks, 50% bonds (times positive)	100% bonds (times positive)
1 year	73%	79%	74%
5 years	86%	94%	93%
10 years	95%	100%	99%
20 years	100%	100%	100%

Source: M.A. Co. Data: *Ibbotson SBBI 2015 Classic Yearbook*

Five years of returns of stocks, bonds and cash

The safest investment, U.S. Treasury bills, has not kept up with inflation.

Years	S&P 500	Long-term government bonds	Treasury bills	Inflation
2010	15.06%	10.14%	0.12%	1.50%
2011	2.11%	28.23%	0.04%	2.96%
2012	16.00%	3.31%	0.06%	1.74%
2013	32.39%	-11.36%	0.02%	1.50%
2014	13.69%	23.87%	0.02%	0.76%
2010-2014	15.5%	9.9%	0.10%	1.80%

Source: M.A. Co.; Data: *Ibbotson SBBI 2015 Classic Yearbook*

Portfolio risk assessment . . . *continued*

Adding time and balance to the analysis

The longer one's time horizon, the lower these investment risks become. There is no 20-year period the past 80 years, for example, in which stocks have posted an overall negative return—including the Great Depression. Despite the bad years at the start of this century, when the Internet bubble popped, the S&P 500 returned 7.7% compounded annually for the past ten years, and 9.9% over the past 20 years.

The other key factor to take into account is that investments don't move up or down in lockstep. That's what makes portfolio diversification so important—when some asset classes are doing poorly, others may be doing well.

Balance the investment classes

The best way to moderate the impact of stock and bond volatility is to own some of each. Asset prices do not move up down in lockstep. When stocks rise, bonds may fall. Or at other times, bonds also may rise when stocks do. The movements of each asset class can be mathematically correlated to the movements of the other classes. *Portfolio optimization* involves the application of these relationships to the investor's holdings.

An *asset allocation plan* is a program of disciplined portfolio diversification. To oversimplify, there are three steps:

- Determine the expected return from each asset category—stocks, bonds and cash. Expected returns may be determined for subcategories as well—small company stocks, corporate bonds, intermediate maturities and so on.
- Decide which combination of these asset classes offers the best return for a given level of acceptable risk.
- Given target allocations, select investments within each class for the portfolio.

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.

An asset allocation plan must take into account an investor's goals, time frames and risk tolerance. Sound portfolio design and management is, frankly, a job for professionals. This is an area where we would be pleased to be of service to you and your family.

Can we tell you more?

Like to know more about our services for investors? Call on us! We look forward to discussing your requirements in detail, in person. ☐

What we bring to the table

We'd like to be able to say that we have a magical solution to every investor's needs right now. We don't. No one does. And you probably already understand that.

What we do have are trust and investment services that are *objective* and *personalized.*

Objective. Our investment advice reflects the same high standards that guide our work as trustee. We don't deal in exotic financial engineering; we invest in instruments that ordinary people have heard of and can understand. To remove any chance of conflict between our organization's interests and our client's interests, we do not work on commission. Instead, we charge moderate annual fees, based on the market value of our clients' holdings. When the dollar value of a client's account grows over the years, we receive more dollars of compensation. If a client's account shrinks in value, so does our reward.

Personalized. As we see it, our business is not simply managing investment programs. Our business is helping people—helping our clients achieve their financial goals. We've learned that serious investors can't settle for a "one size fits all" approach. We see each of our clients as possessing a unique mix of financial facts, family circumstances and personal goals. The better we understand each client's unique situation, including his or her tax picture, the better our chances of retaining the client's business for many years to come.

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The “no inflation” blues

For only the third time since the adoption of automatic inflation adjustments for Social Security benefits, in 2016 there will be no such adjustment. The other two occasions were 2010 and 2011. Officially, prices fell 0.4% for the 12 months used as an inflation yardstick, but benefits are not cut in response to declines in the cost of living. The decline was powered primarily by the substantial drop in gasoline prices. Unofficially, the inflation rate for most retirees probably rose. As a group, they don’t drive as much as those still in the work force or families ferrying children among activities.

What retirees consume more than other segments of the population do is medical services. The U.S. Bureau of Labor Statistics developed the CPI-E to measure changes in the cost of living for those age 62 and older. In the regular CPI, medical care costs comprise 6.2% of the basket, whereas for the CPI-E they are 11.4%, nearly double.

The Medicare Part B angle

Part A of Medicare, Hospital Insurance, is funded by the 2.9% payroll tax. Part B, for physician and outpatient services, is funded in part from general revenue and in part from monthly premiums paid by the beneficiaries. The beneficiaries pay 25% of the total cost. However, premiums are not adjusted each year based upon the same inflation index as are benefits, nor are they adjusted based upon changes in health care price indexes. Rather, they are changes to reflect the actual expenditures under Medicare Part B. From 1980 through 2014, the medical care component of the consumer price index has increased by an annual average of 5.5%. The Medicare Part B premium has increased an average of 7.6% annually, according to the Centers for Medicare and Medicaid Services.

Had 2015 been a normal year, the Medicare Part B monthly insurance premium would have been expected to rise from $104.90 to $120.70. However, it was not a normal year, and the base premium will increase to a projected $159.30, an increase of over 50% per month!

The reason has to do with a “hold harmless” provision in the law. Roughly 70% of Social Security beneficiaries have their Part B premiums subtracted from their monthly benefit. In a normal year, the increase from the inflation adjustment is larger than the increase in the premium, covering the cost. However, when there is no inflation adjustment, as will be the case in 2016, there is also no increase in Part B premiums for this group of beneficiaries. They are “held harmless.”

That means the entire increase is borne by the remaining 30% of Social Security beneficiaries. That includes people just starting their Medicare Part B coverage, those who make direct payments instead of subtracting the premium from their benefits, and high-income retirees who pay more for their Part B coverage. Retirees who are on Medicaid also will have a higher premium, but it will be paid by the government of the state where they reside.

Beat the increase

Those who are on Medicare and who have been delaying claiming their Social Security benefits might want to consider starting their benefits before the end of the year, so as to hold themselves harmless from the premium increase. However, such an approach is more likely to be appropriate for those planning to start their benefits sometime in 2016. Anyone who has been planning to delay benefits for several more years to take advantage of the 8% annual bonus is likely to be better off sticking to that plan and finding the money elsewhere to pay the higher premium.

See your tax and financial advisors before making any final decisions. ☐

Higher-income retirees pay more for their Medicare Part B premiums

The most affluent retirees pay as much as 320% more for their Medicare Part B coverage. Beginning in 2018, the 2.0 multiplier will be increased to 2.6, and the 2.6 multiplier will jump to 3.2.

Singles	Marrieds	Multiplier	2015 premium	2016 premium, not held harmless
<$85,000	<$170,000	1.0	$104.90	$159.30
$85,000-$107,000	$170,000-$214,000	1.4	$146.90	$223.00
$107,000-$160,000	$214,000-$320,000	2.0	$209.80	$318.60
$160,000-$214,000	$320,000-$428,000	2.6	$272.70	$414.20
>$214,000	>$428,000	3.2	$335.70	$509.80

Source: Munnell and Chen, *No Social Security COLA Causes Medicare Flap* (Center for Retirement Research at Boston College, Aug. 2015, No. 15-14)

Which trust would you choose?

This is a true story, from a recent IRS private letter ruling. It shows just how creative some people have been in their trust designs.

Son is the beneficiary of an irrevocable trust, Trust 1, created years ago by an ancestor. Under the terms of Trust 1, Son receives all the net trust income each year for his life. However, when Son is married, his wife receives half, and he receives the other half. If son dies leaving a surviving spouse, she then receives all the net income for her life. Son has adult children from an earlier marriage, and those children are contingent future beneficiaries of Trust 1. Trust 1 principal eventually will pass to Foundation.

Son began cohabiting with Taxpayer. Unbeknownst to Taxpayer, Son created an irrevocable living trust, Trust 2, for her benefit. She is entitled to a fixed dollar amount, paid monthly and subject to adjustments based upon an index, but only so long as they remain cohabiting. After Son dies, the entire principal of Trust 2 will be distributed to Taxpayer in stages, over a period geared to her age.

But there's one catch in Trust 2. In the event that Taxpayer and Son should marry, her interest in Trust 2 will terminate. And there's a way out of the catch. If Taxpayer disclaims her rights to Trust 1, which she would acquire because of the marriage, she may keep her rights to Trust 2.

The couple has married, and Taxpayer proposed to disclaim her interest in Trust 1. The dollar values of the trusts are not given, but evidently the prospect of eventually having 100% of Trust 2 is better than the lifetime income of Trust 1. But there is a tax risk with the disclaimer also. It could be considered a taxable gift by Taxpayer to the other Trust 1 beneficiaries. She turned to the IRS to confirm the tax consequences.

Because taxpayer will make her disclaimer within nine months of the marriage, when her interest vests, the Service holds that the disclaimer will be timely, made within a reasonable time of the "knowledge of the existence of the transfer." The fact that she knew of the trust interest for some time before the marriage does not affect this result. When she makes the disclaimer, the disclaimed interests will pass to other Trust 1 beneficiaries pursuant to the trust terms, not by her direction. Accordingly, she will not make a taxable gift with the disclaimer.

Because Taxpayer was kept in the dark about Trust 2 and had no control over the conditions included in that trust, the IRS holds that her Trust 2 interest will not be consideration provided to induce her to make the disclaimer. Therefore, there will be no adverse tax consequences to the disclaimer. ☐

How risky is your portfolio?

We bring traditional approaches to portfolio management, with traditional balancing of risk and reward. Ask us today about our services for investors and trust beneficiaries.

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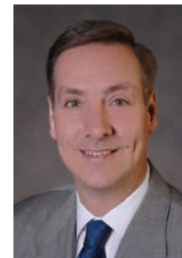

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