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Trust UPDATE

May 2016

Trust: the values we live by

Wealth management with us is a bit different.

There has been a major tug-of-war under way in Washington, D.C., ever since enactment of the Dodd-Frank financial regulation legislation, a struggle over defining the relationship between financial advisors and their clients. When a financial professional provides investment advice, one of two different standards applies:

1. the recommendation is "suitable" for the client; or
2. the recommendation is in the client's "best interest."

To the layman, the difference in these two statements may not seem like much, just semantics. To lawyers and regulators, there is a world of difference. Standard 2 is the "fiduciary" standard, which bars conflicts of interest and may have an effect on the compensation of the advisor. Under Dodd-Frank, the Securities and Exchange Commission has been charged with studying the feasibility of making all financial professionals subject to the fiduciary standard.

When the SEC failed to make rapid progress (perhaps attributable to major resistance from the securities industry), the Department of Labor stepped into the breach, under its authority to regulate retirement plans and IRAs. A year ago DOL proposed applying the fiduciary standard to anyone providing advice for 401(k) participants and IRA owners. The move created considerable anxiety among financial services providers. When the rule was finalized earlier this year, it had been considerably "softened" by DOL, according to industry observers. The truth of that observation was reflected in the spike in share values of publicly traded brokerage firms after the announcement.

Notably, the new rule is being phased in, and it won't be fully effective until January 1, 2018. It does not apply to ordinary taxable investment portfolios.

You don't have to wait

One of the reasons advanced for expanding the fiduciary standard to everyone who gives investment advice is that most Americans already assume that is the rule. Bank trust departments and trust companies already are fiduciaries, and always have been. You could say that we were the pioneers of fiduciary responsibility.

The management of a trust involves much more than day-to-day investment supervision, important though that may be. Trusts typically have several beneficiaries, and these beneficiaries often have interests that are adverse to some extent. They may be of different generations, for example, and their interests in the trust may vest at different times, perhaps years apart. The trustee has fiduciary obligations to each of the benefi-

ciaries, and satisfying these disparate objectives is one of the core responsibilities of trusteeship.

Some trusts permit invasion of principal, either subject to a standard or in the trustee's sole discretion. Some trusts "spray" their income to beneficiaries, in amounts determined appropriate by the trustee. Some trusts include accounting flexibility; that is, items that normally might be credited to principal (such as capital gains) may, should the trustee so decide, be applied instead to income. Decisions such as these are essential to the success of the trust plan.

One might expect the job to be time consuming, and one would be entirely correct. It's understandable that any individual would hesitate to take on the burden of trusteeship when there is an alternative available.

The ability to say no

A trust is, essentially, a long-term wealth management plan created by a trust's grantor. The plan implements the grantor's values and vision. The trustee promises to implement that plan, in a manner consistent with the trust's purposes and instructions.

Does it ever happen that events outstrip the grantor's vision, so that some modifications are needed? Of course. A wide range of developments, from the very good to the very bad, may make the exercise of prudent judgment by the trustee necessary to further the trust's purposes.

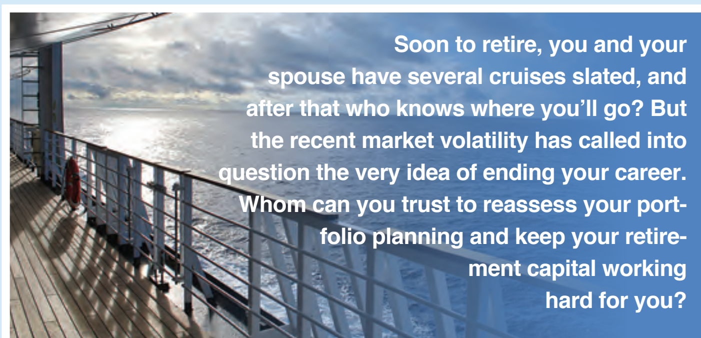
Does it ever happen that beneficiaries would like to have the plan modified, because they don't agree fully with the grantor's vision? Yes, that happens as well. It may happen that a beneficiary wants access to trust capital earlier than provided in the trust, or for purposes outside the trust's limits. Very often beneficiaries don't understand fully the benefits of a trust-based wealth management plan. The trust document should address this possibility. Its provisions must be followed to the letter.

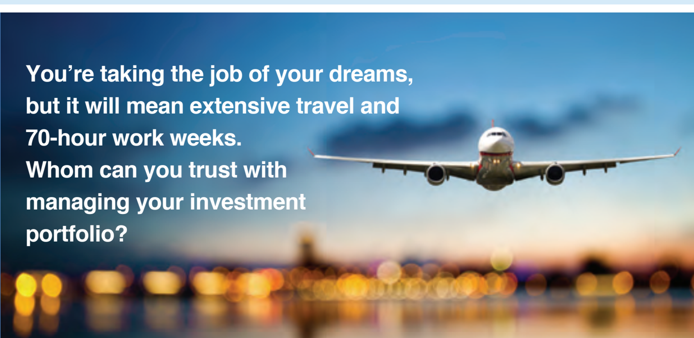
May we tell you more?

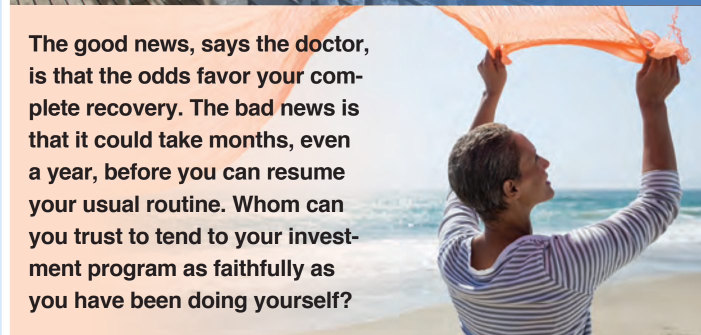
We are well qualified for all the tasks of investment management under the standards of fiduciary responsibility. It is a job that we do every day, with our full attention. We are staffed for it, experienced and always ready to serve.

When you are ready to take the serious step of including a trust in your long-term financial and wealth management plans, please call upon us to learn more about how we may be of service to you. We look forward to answering all of your questions. ☐

Who needs a trust? Imagine yourself facing one of these situations:







People with money to invest are often self-reliant, well enough informed to be able to sort through sales pitches and make up their own minds. They follow the financial press and apply their life experiences as they weigh their investment decisions.

But sometimes people cannot be do-it-yourself investors. Sometimes they don't want to be. As the questions above indicate, in certain situations it's desirable, even essential, to choose an investment manager.

And in making that choice, more and more people are looking for a source of investment guidance that is objective and unbiased. Rather than being on guard for hidden agendas and conflicts of interest, they are looking for an arrangement that is, under the law, structurally immune to such a development.

That's the financial service that we offer.

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Donor-advised funds take off

Fidelity Investments, Charles Schwab and Vanguard Group are not names that one typically associates with charitable giving—but perhaps they should be. They are the sponsors of donor-advised funds, a philanthropic strategy sometimes referred to as a "mini-private foundation," without the tax hassles. These three DAFs are among the top ten organizations in the U.S. in raising money for charity.

Donor-advised funds are structured similarly to community foundations. The donor irrevocably transfers a sum of money to the DAF and secures a tax deduction for the charitable gift in that year. The actual grants to charity occur later, perhaps throughout the donor's life and at his or her death, taking the donor's advice into account.

Fidelity Investments obtained IRS approval for the first DAF in 1991. Vanguard followed in 1997 and Schwab in 1999. By 2003 these three funds held some $3.7 billion and took in $1.1 billion in new contributions. Assets grew to $24.2 billion by 2013, primarily from new contributions and, to a much lesser extent, from investment growth.

More than $70 billion is now held in DAFs in the U.S. In 2014 contributions to all DAFs reached $19.66 billion, and DAFs made $12.49 billion in distributions to operating charities. The average account has about $296,000 in assets.

The growth in this sector alarmed Congress, and so the Pension Protection Act of 2006 called for a Treasury investigation. Key questions included whether the immediate charitable deduction was appropriate, given the donor's continuing control over the funds (even though that control is limited to nominating charitable beneficiaries) and whether DAFs should have a required payout rate.

The Treasury report released in 2011 found that the payout rate of DAFs is higher than that of private foundations. The fact that donors may give nonbinding advice on charitable beneficiaries does not mean that the charitable gift is incomplete, so the charitable deduction is appropriate.

Overblown tax benefits?

Law professor John Brooks has argued that careful examination reveals that in most cases donors would be better off, after taxes, with direct gifts to charity rather than to a DAF ("The Missing Tax Benefit of Donor-Advised Funds," *Tax Notes*, March 1, 2016). Most of the tax benefit goes to the DAF sponsor, in the form of an annual management fee (charged in addition to any fees associated with the investments, such as mutual fund fees). The best after-tax result is obtained with a gift of appreciated securities, which avoids tax on the capital gain while generating a full income tax deduction.

However, the tax benefits may be magnified for those who have spikes in income. Also, if one believes that certain holdings have peaked in value, a gift to a DAF can lock in that value against an expected future decline.

Alternatives

Among the other choices in planned giving are charitable remainder unitrusts, charitable remainder annuity trusts, and private foundations. As the table above shows, these strategies are not growing nearly as dramatically as DAFs. However, they may offer advantages of their own to philanthropically minded families. ☐

Charitable giving vehicles
(billions of dollars)

	2013	2014	% change
Donor-advised funds	$57.08	$70.70	23.9%
Charitable remainder unitrusts	$81.91	$78.71	-3.9%
Private foundations	$654.31	$695.30	6.3%
Charitable remainder annuity trusts	$5.97	$5.52	-7.5%
Charitable lead trusts	$25.85	$28.20	9.1%
Pooled income funds	$1.23	$1.21	-1.6%

Source: National Philanthropic Trust, http://www.nptrust.org/daf-report/giving-vehicle-comparison.html

Student debt and retirement savings

The high cost of higher education and the burden of student debt have emerged as issues in this year's political races. Perhaps that's because over the last two decades the number of households carrying student debt has doubled, and the average inflation-adjusted balance has nearly tripled.

Starting a career with that much debt has far-reaching consequences. According to Jake Spiegel of HelloWallet, writing in *Morningstar* (April/May 2016), one of the effects may be a reduction in retirement savings. His firm studied how workers use their discretionary dollars. Do they pay off the student loans early, or do they boost retirement savings, such as increasing their 401(k) deferrals?

There is a definite crowding-out effect from student loans, the firm discovered. The amount of the decreased retirement savings ranged from $0.17 to $0.35 for each additional dollar of student debt.

Should student loans be paid off early? Not at the expense of saving for retirement, the authors report. Everyone should always defer at least enough to capture the entire employer match in a retirement plan. They offer the example of a 25-year-old worker with $20,000 of student debt and a gross salary of $50,000 whose employer offers a 5% match. If this person utilizes only half of the match in order to pay down the student debt more quickly, he or she will have $242,000 less net wealth at age 65, the authors calculate.

Even if the interest rate on the student loan is higher than the expected total return from the retirement deferral, the retirement should retain first priority, they argue. That's because there may be tax benefits for the student loan interest, and the earlier one begins saving for retirement, the longer the money has to compound. ☐

Notable

Mutual fund investors are like anyone else—they find their time consumed by jobs, family obligations, and the myriad of other priorities we face in today's world. They are lucky if they can make it to the gym in their spare time. So, to expect most investors to closely follow the performance of their fund investments, let alone their fee structure, management changes and investment risks, would be unrealistic. And, of course, it is fund directors, not fund investors, who have access to the information and critical participants, like the fund adviser, that makes strong and meaningful oversight possible.

—SEC Chair Mary Jo White, March 29, 2016

Trusts aren't about money.
Trusts are about people.

Speak to our trust and investment advisors to learn how a trust can enhance your family's financial security.

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