I N T H I S I S S U E

Trust UPDATE

Stillman BANK

Get me off the investment roller coaster!

One thing that "everyone knew" about Brexit, the vote in Britain to leave the European Union, was that the "Leave" campaign had little chance of success. Both major parties and most of the politicians were actively campaigning to "Remain." The economic consequences of the Leave were almost too dire to contemplate.

That made the outcome all the more shocking. The margin of victory for Leave was decisively higher than pollsters predicted. One thing is certain about financial markets—investors hate uncertainty. They hate being surprised. The next day Japan's Nikkei dropped 8%; France's CAC fell 10% in two days; and the S&P 500 lost 5% in two days. The airwaves and Web sites were flooded with dark speculation regarding "what does this mean?"

One thing that no one predicted the day after Brexit, one thing that no one even hinted at, was that within weeks the American stock markets would soar to record highs.

That is the definition of an investment roller coaster.

Risks in the short term

In hindsight, Brexit looks more like a buying opportunity than a harbinger of doom. However, it could yet prove to become a turning point concerning the path of globalization and freer worldwide trade. Should that happen, global economic growth could slow from today's already weak rates.

To exit the investment roller coaster, investors need to assess their risks and, in general, lengthen their time horizons.

For short-term investors—people who will need to sell in a few years—

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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.
- Long-term bonds also can be surprisingly risky for investors with relatively short time horizons, such as ones who may have to sell bonds 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%.

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 over the past 80 years, for example, in which stocks have posted an overall negative return—including ones that encompass the Great Depression.

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 expecting 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 they 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?

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. 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. We provide asset allocation planning for investment management accounts and our trust services.

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. ☐

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%	1981-91	-0.07%	1950-59
U.S. Treasury bills	11.12%	1979-83	0.05%	2010-14	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 2015 Classic Yearbook*

Although stocks had a great run in the 1990s, the best ten-year period for stocks came in the recovery that followed World War II. The worst ten-year period for 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.

What's the best age to receive an inheritance?

In a recent interview with *Tax Notes,* estate planner Jonathan Blattmachr discussed the inheritance paradigm that was in place when he entered the profession in the 1970s. The usual pattern for dispositions to children was to create a trust for them, with the distribution of one-third of the assets at age 25, half of what was left at age 30, and the balance outright at age 35. The reasoning was that spreading the inheritance over a ten-year period would allow the heir to acquire financial maturity, and reduce the chance of the inheritance being squandered.

Blattmachr didn't agree with this thinking. He thought that the benefits of trust management of wealth ought to be made to last a lifetime. When Blattmachr's father asked him when he wanted to receive his own inheritance, Jonathan replied: "Why would I want the money so some client can sue me and take it away? So my wife can take it in a divorce? So when I'm an old man, some sweet young thing can swindle it out of me? I want the property in trust for life."

Of course, at the time of that conversation Blattmachr was already a successful lawyer and had no urgent need for quick access to an inheritance. When the financial situation of the heir is unknown, a trust for life may not be the best approach.

Entitlement worries

One of the concerns that some wealthy parents have is that early access to an inheritance may rob their children or grandchildren of ambition, that they may come to feel entitled to success without working for it.

That was the subject of a *Harvard Business Review* article by Josh Baron and Rob Lachenauer, "Keep Your Kids Out of the Entitlement Trap" (February 2014). The authors are co-founders of Banyon Family Business Advisors and have considerable experience in providing practical inheritance advice. They suggest asking these four questions about potential heirs:

- Do they hold down jobs?
- Can they build careers?
- Are they allowed to suffer?
- Are they grateful?

If the answer to all four questions is "No," the chance of being on the entitlement path goes up.

But having said that, the best approach remains unclear. For Jonathan Blattmachr, all answers were likely "Yes," yet the best strategy was to leave the inheritance "tied up" in a trust for life. In another family, four "yeses" might suggest that an immediate outright inheritance is appropriate.

The authors conclude with this observation: "But one last word: in our experience, the way that the most successful business families curb the next generation's sense of entitlement is by staying involved in their kids' lives. If they fail to get some quality time, your children turn to money as the next best substitute. That sounds trivial, trite, perhaps even a platitude. But every child is entitled to love. The rest is gravy." ☐

Tax-free reimbursements

A major natural gas leak was discovered in California in October 2015. The leak was not capped until the following February. Nearby residents lodged a variety of complaints, and many required temporary relocation. The utility was ordered to pay for or reimburse certain cleanup and relocation expenses.

The IRS now has held that the reimbursements will, in general, not be taxable income to the affected homeowners. That includes hotel costs, food costs, expenses of renting another home, or expenses of up to $150 per day for staying with friends or family. However, the friend or family who accepted that $150 per day *will* have taxable income, unless the rules for short-term rental of a residence are met.

Deterioration is not a casualty

Christina lived in Castle Village, a housing complex overlooking the Hudson River in New York City. In May 2005, after an unusually wet spring, a retaining wall collapsed. Christine claimed a casualty loss deduction of $23,188 for that year. When the IRS disallowed the deduction, Christine filed an amended return with a deduction of $149,843, representing the loss of value to her property resulting from the sudden collapse of the retaining wall.

The Tax Court ruled for the IRS. The evidence showed that the wall had been deteriorating for at least 20 years. To qualify as a casualty loss, the damage must be from a fire, storm, shipwreck or similar disaster. Damage that is merely accelerated by a rainstorm does not qualify.

Old age is no excuse

Mark and his wife sent the IRS a check for $10,000 on April 15, 2012, and requested an extension of time to file their tax return. They made another payment of nearly $11,000 on October 26, 2012, after filing their tax return on October 15. That was enough to cover the income taxes due, but the IRS also assessed a late filing penalty and a late payment penalty, as well as interest.

Mark contested the penalties and the interest. The reason for his late filing? He is old, and the tax code is too hard to understand. The Tax Court was sympathetic, but Mark's excuse is not acceptable.

No EITC for disability income

Eva timely filed her tax returns for 2006 through 2010, reporting disability income of $10,000 to $11,000 each year. She also claimed the earned income tax credit (EITC) of nearly $3,000 for each year. Because the EITC is refundable, Eva expected a refund check, even though she had not had any tax withheld during the year.

The Tax Court ruled against her. Disability income is not "earned income," which is wages, salaries, tips or other employee compensation. Pension income, worker's compensation, annuity income or welfare payments do not count as earned income. ☐