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# Trust UPDATE

Stillman BANK

## IRAs: Foundation for a secure retirement

The Individual Retirement Account began life in 1974, as a component of the Employee Retirement Income Security Act (ERISA). ERISA was designed to require private companies to use "best practices" in providing retirement resources for their employees, notably in funding their pension promises. Most observers agree that it has achieved its purposes, although one unintended consequence as been that defined benefit plans—pensions, in the usual parlance—have given way to defined contribution plans—401(k) plans being the leading example.

What about those who had no employer-provided retirement coverage? The IRA gave them the opportunity to set aside $2,000 each year into a tax-deferred account for retirement. In 1981 the IRA savings choice was extended to all working taxpayers. Since then the contribution limits have been increased, and limits have been imposed on the deductions for higher-income taxpayers.

Given the low limits on contributions, it may come as something of a surprise to learn that today IRAs hold 31% of all retirement savings assets, a larger share than 401(k) plans, private pension plans, or public pension plans. See "Total retirement assets and unfunded pension liabilities" below for details.

Some 40 million U.S. households have at least one IRA. About 30 million households have a traditional IRA, and 20 million have a Roth IRA (10 million have both). When taxpayers make new IRA contributions, they generally choose a Roth IRA. Traditional IRAs are now largely funded by rollovers from employer plans.

That explains why IRAs now rival 401(k) plans in total assets, as the IRA is the ending vehicle for a lifetime of accumulation in an employer plan.

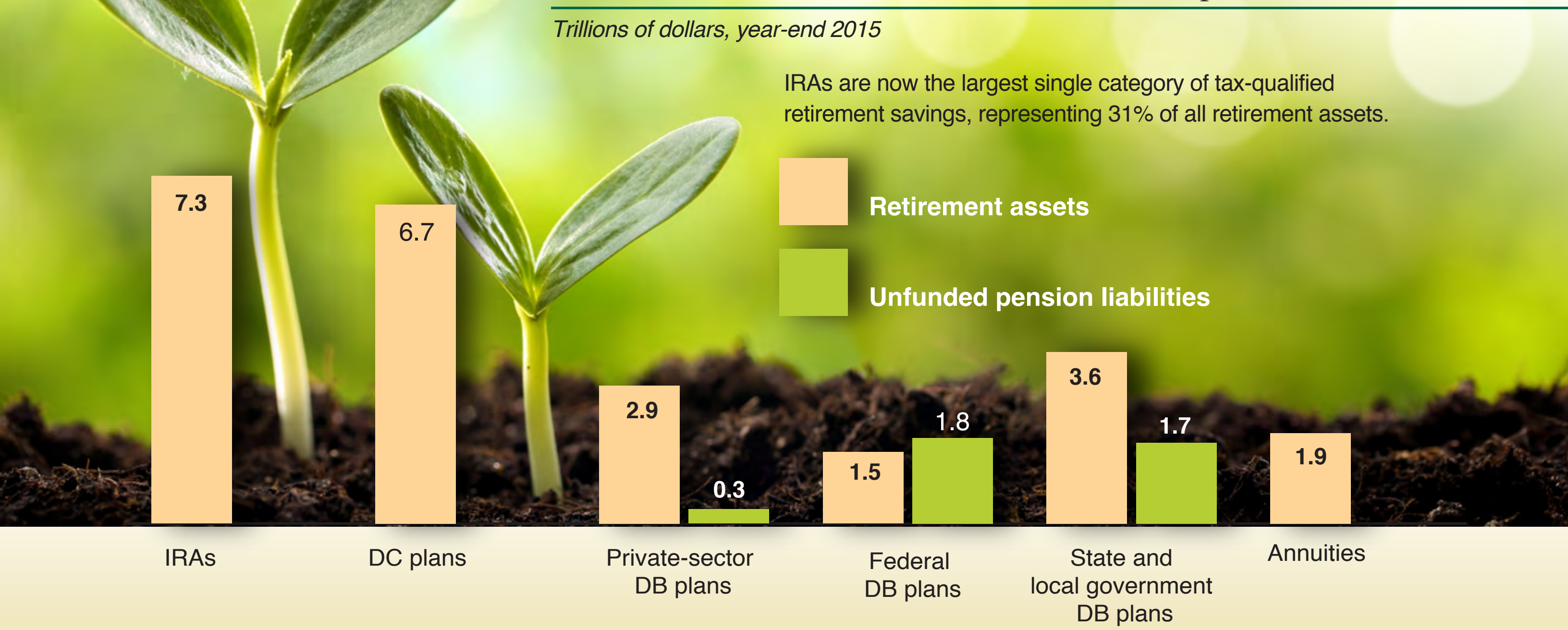
### *Investment decisions*

The *2016 Investment Company Institute Fact Book* compared the typical portfolios of IRA owners in their 30s with those in their 60s. Interestingly, both groups had just over 50% of retirement money in stocks.

In contrast, Roth IRAs have some 60% of assets in

Total retirement assets and unfunded pension liabilities

*Trillions of dollars, year-end 2015*




Source: *2016 Investment Company Fact Book*; M.A. Co.

equities. See “The asset allocation decision” below or more analysis. Evidently, the freedom from income taxes offered by the Roth IRA encourages the account owners to take on more risk. And who doesn't love the prospect of tax-free capital gains?

If you have significant savings in taxable accounts, you don't want to evaluate your investment strategy for your IRAs in isolation. You'll need to decide whether your stock investments belong in the IRA or on the taxable side of the ledger. All the distributions from the IRA will be taxed as ordinary income, whether they are of interest, dividends, capital appreciation or return of principal. For the sake of tax efficiency, many advisors suggest focusing the IRA on providing steady income (investing primarily in good-quality bonds) and doing the growth investing outside of the IRA

## Distributions

Owners of Roth IRAs tend to avoid taking money out, according to the *Fact Book*. For each age group, 5% or less took money out of their Roth IRA in the reference year. Withdrawals for traditional IRAs are being used for retirement living. For those age 25 to 59, only 9% made a withdrawal, which makes sense, given that there will be a 10% tax penalty in most cases for this group. Those in their 60s avoid the penalty tax, and so 21% tapped their IRA. According to the survey, only 80% of those 70 and older were taking withdrawals, which is surprising, given the minimum distribution requirements that kick in at age 70½.

As one would expect, 48% of those who withdrew money from an IRA used it for routine retirement living expenses. Some 36% needed the money for health care expenses, and 23% used the money for some other emergency.

However, the IRA money may be used to improve the quality of life. Some 25% used the funds for a home purchase or remodeling, and 12% bought a car, boat or other big-ticket item with it. About 37% reported moving the money to a taxable account.

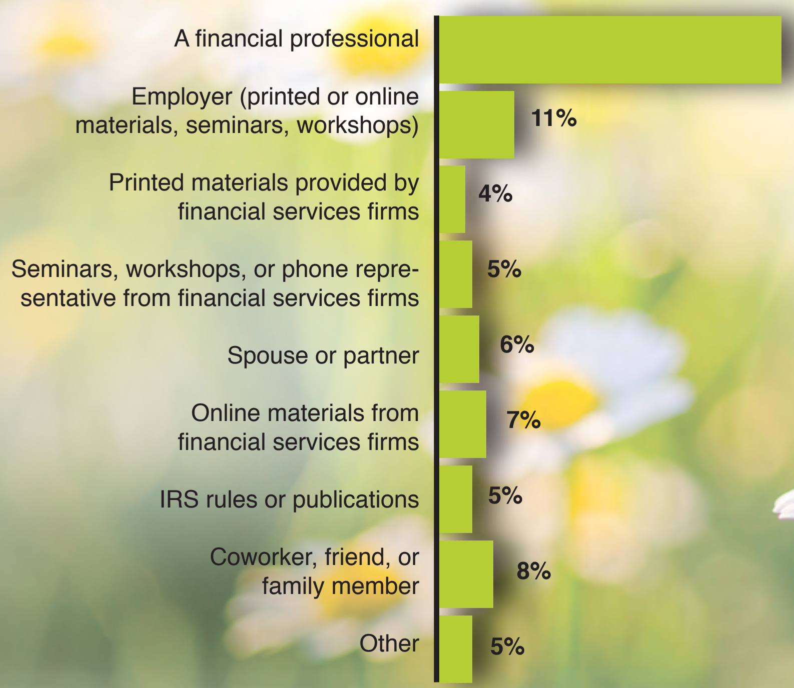
## Getting help

The same report looked at where those approaching retirement turn for advice when it comes to rolling money over into an IRA. The sources are surprisingly diverse—see “Sources of advice” for the list. Financial professionals, such as ourselves, were consulted 63% of the time, and nearly half of the respondents named financial professionals as the primary source of advice.

Are you expecting a lump sum payout from a retirement plan in the next year or so? Or do you have questions about your retirement readiness? We'll be pleased to offer you our assistance with these important financial planning issues. ☐

## Sources of advice

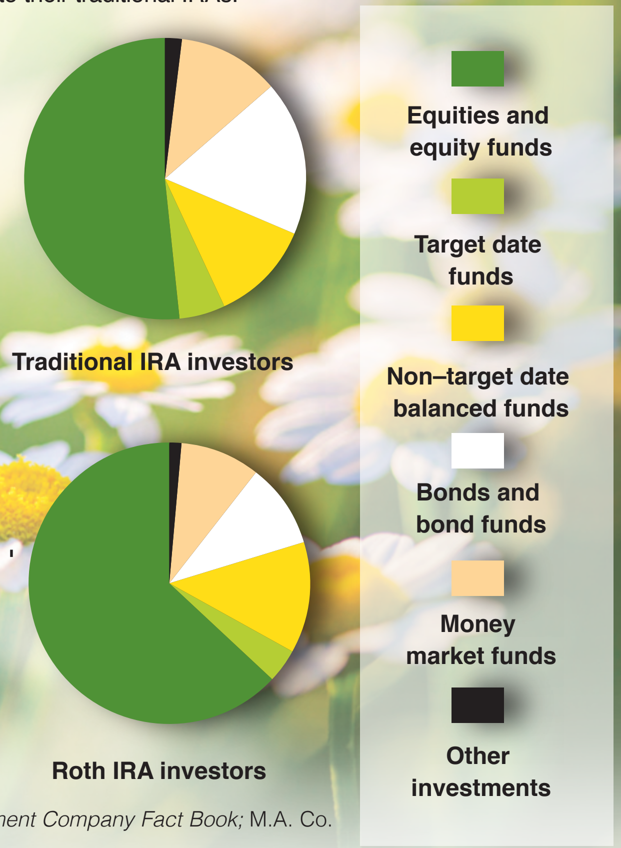
When it comes to deciding on an IRA rollover, surveys show that a wide variety of sources may be consulted. Nearly half named a financial professional as their primary source.




Source: *2016 Investment Company Fact Book*; M.A. Co.

## The asset allocation decision

Interestingly, surveys do not show a substantial change in investors' willingness to accept equity risk as they age. They do, however, tend to increase their stock positions in their Roth IRAs compared to their traditional IRAs.




Source: *2016 Investment Company Fact Book;* M.A. Co.

# The DJIA broke 20000.
## *Now what?*

Milestones in the stock indices are arbitrary. Nevertheless, they have an indisputable psychological power in the minds of investors. Investors cheered when the "barrier" of 20000 on the Dow Jones Industrial Average (DJIA) was broken on January 25, 2017, and a mighty roar was heard on the floor of the New York Stock Exchange. To get to 10000 on the Dow required 103 years. Getting to 20000 was just 18 more.

Strengthened corporate earnings are an important foundation for the run-up in stock prices. The other element is a surge of optimism among investors, consumers and business leaders. Economist Stephen Moore noted that the total value of U.S. stocks has increased by $2 trillion since election day in November.

### *Every silver lining has a cloud*

One way to quantify investment sentiment and willingness to accept risk is the price/earnings ratio. How much is a given stream of earnings worth to investors? When the p/e ratio is high, stocks are expensive. How pricey are stocks right now? For the large-cap stocks, the p/e ratio is also near record levels.

The trailing 12-month p/e of the DJIA is 20.6; that is, investors are paying $20.60 for every dollar of earnings. That's higher than it was just before the last recession started. Robert Shiller has devised a variation on the p/e ratio, the CAPE ratio, which uses a 10-year window of earnings of the S&P 500 and includes an inflation adjustment. The CAPE stood at 28.48 as the DJIA crossed 20000. The CAPE was not that high even on Black Friday in 1929. The only period during which that metric was higher was during the dot-com bubble.

Investors appear to believe that stronger economic growth is coming, which will justify the high stock prices. The engines of growth are expected to be regulatory reform, tax reform, and new infrastructure spending. President Trump announced a 4% growth target for the economy, which could power the market still higher.

### *How to respond*

Passing a stock index milestone is not a signal to buy or sell. However, it does focus attention on the market, and it may cause some investors to evaluate their portfolio. There can be a strong temptation to "take some money off the table."

How close are you to retirement? How much risk are you willing to assume? Those answers are better clues to making an investment decision that allows you to sleep well at night.

This could be a time for portfolio rebalancing, if you haven't made this assessment recently. If your asset allocation target was 60% stocks, 40% bonds, you may find that the stock portion has now grown to 70%. That means your portfolio is now riskier than it used to be. If that makes you uncomfortable, you need to sell some stocks and invest in bonds, to keep your allocation steady.

On the other hand, bonds have risks of their own, as interest rates are likely to rise in the coming years, in order to return to more normal levels. That will push down the value of previously issued bonds. What's more, if you share in the optimism about the economy, this might not be the right time to reduce your exposure to growth.

### *Trusted advice*

If you might benefit from a second opinion on your investment strategies or the composition of your portfolio, we would be pleased to meet with you to discuss your situation. Investment management throughout market cycles is a core element of our daily business. We will be pleased to share our expertise with you. ☐

### Fast facts about the Dow Jones Industrial Average

- First close above 1000: November 14, 1972
- First close above 10000: March 29, 1999
- First close above 20000: January 25, 2017
- Trailing p/e at 10000: 23.8
- CAPE ratio at 10000: 42.70
- Trailing p/e at 20000: 20.6
- CAPE ratio at 20000: 28.48
- Fastest move between 1000 point milestones: 24 days, May 3, 1999
- Second-fastest move between 1000 point milestones: 42 days, January 25, 2017

## Offense and defense on a tax perk

The U.S. tax code has long allowed a "minister of the gospel" to exclude from his taxable income a "rental allowance paid to him as part of his compensation." Two persons from the Freedom from Religion Foundation have challenged the constitutionality of that provision, as secular persons are not afforded the same tax exemption. They argue that this amounts to an "establishment of religion" in violation of the First Amendment.

Two clergymen and the Chicago Diocese of the Russian Orthodox Church have asked to be allowed to intervene in the case. The government is charged with defending the constitutionality of the tax code, but the clergy argue that they will raise issues and facts of which the government may not be aware. Furthermore, they wish to argue that elimination of the exemption would be a violation of *their* constitutional rights.

In January the Tax Court agreed to permit the clergy to join the case.

## More tax fallout from the Madoff fraud

James Heller's $26 million estate included a 99% interest in an LLC whose sole asset was a $16.5 million Madoff Securities account. Heller's daughter and son each owned a 0.5% interest in the LLC. Heller died on January 31, 2008. To pay taxes and administrative expenses, his executors withdrew $11.5 million from the Madoff account. The son and daughter received $115,000, and the remaining $11.385 million covered the estate's immediate liquidity needs. The withdrawals began on March 4, 2008, and were completed by November 28, 2008.

Just in the nick of time (perhaps). On December 11, 2008, Bernard Madoff was arrested for a multibillion-dollar pyramid scheme, to which he eventually pled guilty. The remaining $5 million in Heller's Madoff account immediately went to zero. On its estate tax return, filed on April 1, 2009, the estate showed the full nominal value of the Madoff account at the time of Heller's death, and it claimed a $5.1 million theft loss deduction for the loss in the account's value during the period of administration.

The IRS did not dispute the fact of the loss, or that it was due to fraud. Rather, it argued that the loss belonged to the LLC, not to the estate.

The Tax Court disagreed, in a case of first impression. The loss suffered by the estate relates directly to the LLC, which became worthless because of the fraud. What's more, allowing the theft loss is consistent with the overall statutory scheme of the estate tax.

Summary judgment for the estate was ordered. ☐