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Trust UPDATE

Stillman BANK

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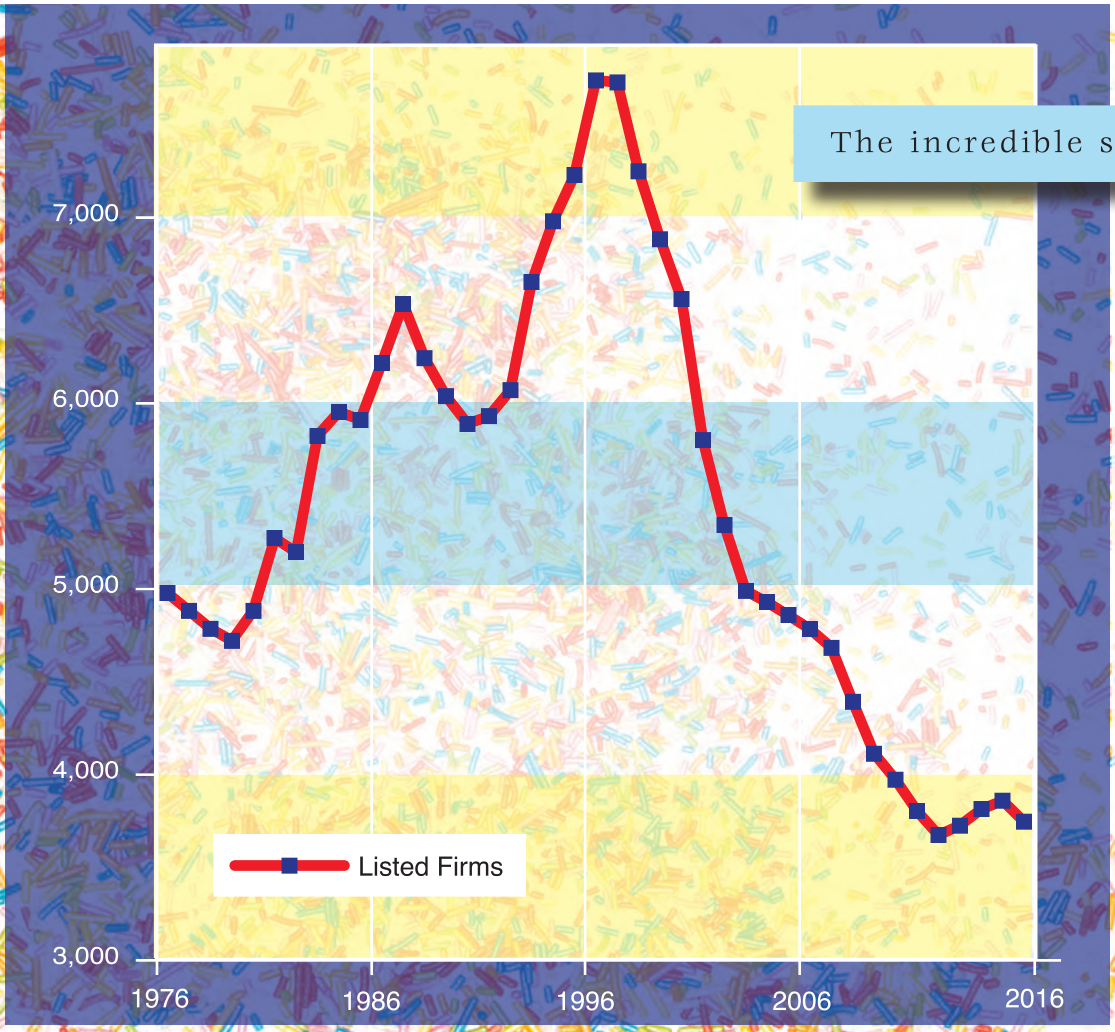
The stock market is disappearing before our eyes

Equity investors have welcomed the robust growth in stock prices this year, as the stock indices repeatedly have reached new highs. A combination of steady economic progress coupled with a burst of enthusiasm for the future seems to be what is powering the markets now. The question remains, as always, how long can the good news last?

But something else is happening in the stock markets as well. The number of stocks listed on the exchanges is in steep decline. A study released by Credit Suisse last March documents the phenomenon in detail. As the graph below demonstrates, the number of listed stocks on U.S. exchanges peaked in 1996 at 7,322. Today there are roughly half as many, 3,671. And that number is 20% lower than the number of listed stocks in 1976!

From 1976 to 1996, Gross Domestic Product (GDP) in the U.S. grew by about 90%, according to the study. During that time frame, the number of listed stocks grew



The incredible shrinking stock market

The number of firms listed on U.S. stock exchanges peaked in 1996. Since then, delistings have outpaced new listings every year but two. Today there are roughly 50% fewer stocks to choose from traded on U.S. stock exchanges compared with the peak year of 1996, 20% fewer than in 1976.

Source: M.A. Co. Data from Credit Suisse, *The Incredible Shrinking Universe of Stocks*, March 22, 2017 by roughly 50%. In the next 20 years, from 1997 though 2016, GDP rose by another 60%, but the number of listed stocks fell by about half.

What happened?

There are many factors that have led to the reduction in listings. It's not that there are few companies being formed. The number of firms eligible to be listed has grown slightly, from 550,000 in 1996 to 590,000 today.

Instead, it seems that the benefits of being a listed company have declined, while the costs have increased. The benefits include:

- the ability to raise funds through the public market;
- being able to use shares as currency, to compensate employees or engage in mergers and acquisitions;
- creating liquidity for shareholders;
- establishing trust among investors by meeting the legal standards and disclosures required to be a publicly traded company.

How the universe of publicly traded stocks has changed

	1976	1996	2016
Number of listed companies	4,796	7,322	3,671
Market capitalization ($ billions)	$2,975	$12,322	$25,303
GDP ($ billions)	$6,325	$11,769	$18,565
Ratio of market cap to GDP	47.0%	104.7%	136.3%
NYSE annual share volume (millions)	5,360	104,636	316,495
Average age of a listed company (years)	10.9	12.2	18.4
Average size of a listed company ($ millions)	$620	$1,683	$6,893
Mutual fund assets under management ($ billions)	$40	$1,725	$8,725

Source: Credit Suisse, *The Incredible Shrinking Universe of Stocks*, March 22, 2017

However, that last point suggests how the costs have grown:

- expenses for mandatory disclosures have risen, especially in the wake of the Sarbanes-Oxley Act of 2002;
- mandatory disclosures may create competitive disadvantages, alerting competitors to a firm's plans and resources;
- quarterly earnings reports create a short-term focus;
- pressure from activist investors.

The bottom line is that publicly traded companies tend to be older and larger than in the past.

Exits and entrants

There are three reasons that a firm may be delisted from a stock exchange. Least common is a voluntary withdrawal, in which the firm's owners simply decide that the benefits don't justify the costs. Next, a firm may be forced out for cause, because it no longer meets the requirements to be listed, such as minimum assets or minimum capitalization. The most common reason, accounting for 60% of all delistings since 2010, is a merger or acquisition of a company.

Most M&A deals are strategic. Think of Berkshire Hathaway acquiring another company. The equity of the acquired company is still available to investors, but they must instead buy Berkshire Hathaway to get it. The resulting companies tend to become more profitable, and industries may become more concentrated.

The rest of M&A consists of financial deals, in which companies are taken private. In 1980 the 24 private equity firms then in existence had deals worth $1 billion. Today there are more than 3,000 private equity firms, and they have roughly $826 billion under management. The investing public no longer has a way to invest in companies that are taken private.

On the other side are the initial public offerings. IPOs continue to be important, but the volume of IPOs has not kept pace with the number of delistings. From 1976 through 2000, the average number of IPOs was 282, hitting a peak of nearly 700 in 1996. Since 2000, the average has fallen to 114 IPOs per year.

In part this phenomenon may be attributable to the greater availability of late-stage capital available to young companies today. New firms may also have less need of capital to grow. For example, where Walmart needed $135 billion of invested capital to generate 2016 sales of $486 billion, a capital velocity of 3.6, Amazon generated $136 billion in sales with only $19 billion of invested capital, a ratio of 7.1.

Filling the vacuum

In 1976, 50% of stocks were owned directly by individuals. Now only 21% are, as individual investors have turned to mutual funds and exchange-traded funds (ETFs) to complete their portfolios. The majority of listed stocks today are owned by institutions, up from 20% 40 years ago.

ETFs began to gain in popularity about the time that the number of listed stocks began to fall. From assets of just $2 billion in 1996, ETFs now have $1.8 trillion under management. ETFs give investors an alternative to buying and owning stocks directly, and they can be used to build relatively lower-cost diversified portfolios.

What about *your* portfolio?

What do these changes mean for the management of your investment portfolio? We'd be happy to share our perspectives with you in the context of your own holdings. Please give us a call to arrange for an introductory meeting with our trust and investment professionals. ☐

Asset protection trusts

As has been noted often, the wealthy want their heirs to have enough to be able to do anything, but not so much that they don't have to do something. Trust planning comes immediately to mind when planning for a child who is a minor. The trust can provide for education funding, for getting a good financial start in life. Incentives can be built into the trust for achieving certain milestones, such as reaching a certain age or beginning a professional practice.

But what about when the children are fully grown, established in their careers and financially mature, in their 30s or even 40s? Even then, trust-based planning will be an excellent idea for many affluent families.

Basic tools

A great variety of financial protection strategies may be implemented with careful trust planning. Among the choices to evaluate:

- ***Gift-to-minors trust.*** For young children, contributions of up to $14,000 per year to this sort of trust will avoid gift taxes. A married couple may together set aside $28,000 each year for each child or grandchild, so in a few years a significant source of capital may be built up. Assets may be used for any purpose, including education funding, and will be counted as the child's assets for financial aid purposes. The assets of a gift-to-minors trust must be made fully available to the child when he or she reaches age 21. However, the child may be given the option of leaving the assets in further trust.
- ***Support trust.*** For an adult child who needs a permanent source of financial support, with the trust principal protected from the claims of creditors, a support trust may provide a solution. The beneficiary's interest is limited to so much of the income as is needed for his or her support, education, and maintenance.
- ***Discretionary trust.*** The trustee has sole discretion over what to do with the income and principal, just as the grantor does before the trust is created. The beneficiary has no interest in the trust that can be pledged or transferred. When there are multiple beneficiaries, the trustee may weigh the needs of each in deciding how much trust income to distribute or reinvest, when to make principal distributions, and who should receive them. The trust document will often include guidelines on such matters.
- ***Spendthrift trust.*** The beneficiary is forbidden to transfer any financial interest that he or she has in the trust, and may not compel distributions.

Here's an example of how such a trust may work.

A trust in action

Alice tried to treat each of her four children fairly throughout their lives. That didn't mean she treated them equally. Three of the children went to college, two to graduate school. The fourth child developed substance abuse problems. The rehabilitation costs almost looked like college tuition expenses at times.

Alice isn't keeping score as she provides her children with financial help. Some families have unusual financial needs. Alice wants to apply her financial resources where she believes that they will do the most good. That may mean that the most financially successful of her children will get only a nominal inheritance, while others will get more. Yet she also knows that fortunes can shift over time, that the person who is successful today might suffer a reversal tomorrow. Thus ongoing monitoring is an essential component of her long-term planning.

A discretionary trust plan for managing the inheritance of Alice's children can have this same flexibility built into it. The trustee can evaluate the status of the children and their families and adjust the trust distributions in accordance with the guidelines set down in the trust.

Our invitation to you

We specialize in estate settlement and trusteeship. We are advocates for trust-based financial planning. If you would like a "second opinion" about your estate planning, if you have questions about how trusts work and whether a trust might be right for you, we're the ones you should turn to. We'll be happy to tell you more. ☐

Proof of gift

On their 2011 tax return, Mr. and Mrs. Ohde claimed a charitable deduction of $145,250. The couple say that they had donated, during that year, some 20,000 items to Goodwill Industries. The donations included 115 chairs, 20 chests of drawers, 16 bedframes, and $71,434 worth of clothing and accessories, among other items. When the Ohdes' return was audited, the IRS reduced their charitable deduction to $250, which also triggered a 20% penalty on the underpayment of tax.

The couple took their case to the Tax Court, where they produced a spreadsheet showing the dates of their donations. The values ranged from $830 to $14,999 per trip. Four times their donations were worth exactly $5,000; twice they were worth $4,999; three times they were worth $5,008. The spreadsheet was not created until long after the gifts were made; the only contemporaneous records were receipts from Goodwill stating that a donation had been accepted. However, those receipts had no details on the donated property other than a category (clothing, furniture, etc.). There was no indication of the number of donated items, their condition, or their value.

Charitable gifts of property other than cash are subject to very specific rules to support the deduction. Gifts of $250 or more must be documented with a contemporaneous written acknowledgment (a "CWA") that includes a description of the property. If the claimed value exceeds $500, the taxpayer must supply the manner of acquisition (purchase, gift, or inheritance), the approximate date of acquisition, and the cost or adjusted tax basis of the donated items. When the $5,000 threshold is crossed, a qualified appraisal of the property is required.

What's more, similar items must be aggregated together to determine which of these rules will apply. The fact that each of the 3,152 books that the couple gave to Goodwill was worth less than $250 is not important; the fact that the total claimed value of those books was $25,026 is what matters. That is what triggers the "qualified appraisal" requirement.

The Tax Court found that the Ohdes had failed to maintain the required records to support the claimed deduction. Even the CWA provided by Goodwill was inadequate, because its description of the donated property lacked required detail. What's more, the Court stated that "Petitioners' assertion that they donated more than 20,000 items to Goodwill in a single year is implausible on its face," and so an accuracy-related penalty was appropriate.

The bad news may not be over for the Ohdes. Only the 2011 tax year was at issue in this case. The Court noted that the Ohdes had claimed donations to Goodwill of $292,143 for 2007-2010, and $104,970 for 2012-2013. The IRS seems likely to disallow any of those claims for which the statute of limitations has not expired. ☐