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Trust UPDATE

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The great debate: *Active* or *passive*?

When it comes to investing, there are no easy answers.

What kind of investor are you? An *active investor* is one who seeks to outperform the market, to invest in winners while avoiding losers, and who responds to market dynamics with portfolio repositioning from time to time. The *passive investor*, on the other hand, is satisfied to just get market returns. The loss of upside potential is balanced by the fact that returns will be no worse than the market. Passive investors may choose index funds, while active investors prefer to own individual securities or actively managed mutual funds.

One advantage of passive investing is the low cost. Active management tends to incur transaction costs and tax costs, and the advice of an experienced investment manager is not free. Some investment managers will beat their benchmarks; others will not; and costs figure into that performance. A 2016 study by S&P Dow Jones Indices suggested that some 90% of active managers missed their targets over various time frames. That may be part of the reason for more and more money moving into passive funds over the last decade. Ten years ago the market share of passive funds stood at 20%, and that grew to about a third by the end of 2017, according to Bloomberg. Passive investing also is growing more popular in Europe, but there it accounts for only 15% of funds.

Active managers have the flexibility to increase exposure to promising sectors of the economy and to avoid those showing weakness. They may be able to use short

Active vs. passive investment approaches

	PRO	CON
Passive investing	Lower fees Easy to understand Tax efficient Will do no worse than the market generally	Limited to available indexes Can't outperform the market
Active investing	Flexibility Hedging Tax management May outperform the market May be superior in down markets	Higher fees More risk

Source: M.A. Co.

sales or put options as hedges against downturns, and they can sell a stock that seems clearly headed for a fall. The index investor necessarily owns all the stocks in an index until a stock is removed from it.

An investment manager may be able to tailor a strategy for tax efficiency, for example, by selling stocks that have lost value to offset other realized gains on sales. Interestingly, even hedge fund managers, who are among the most highly compensated of the active investment managers, have a portion of their holdings in passive funds, according to Investopedia.

In a rising market, with a strongly growing economy, many investment strategies will look good, including passive ones. But when a bear market emerges, most investors will favor taking steps to preserve capital, and not simply accept a portfolio meltdown.

Preparing for a bear market

The business news has been quite good in 2018, as the economy has outperformed the predictions of many experts. One happy result is a series of new records for the stock market indices. The leaders have been Facebook, Amazon, Apple, Netflix, and Google (the so-called "FAANG" stocks).

However, bull markets do not last forever, much as we may wish that they did. One defensive measure to take is to allocate more of the investment portfolio to fixed-income investments, such as bonds. However, we still are in an era of abnormally low interest rates, in which generating significant income from a bond portfolio is difficult. Also, given that the Federal Reserve appears poised for more rate increases, bond values could be at risk.

When a bear market does emerge, history suggests that the safest stocks are likely to be utilities and consumer staples, followed by health care and telecommunications. See "A tale of two recessions" below for more details.

At the moment, few if any are predicting a bear market in the foreseeable future. But bear markets don't often announce their arrival with great fanfare, so the prudent investor needs to stay alert.

How about you?

We provide objective investment advice, and we manage investment portfolios. Our fees are geared to our responsibilities. We help to optimize portfolios for risk and reward, consistent with our clients' investment goals and objectives.

Would you like to know more about our capabilities? We would be pleased to meet with you at your convenience, to lay out our credentials and offer our insights in more detail. ☐.

A tale of two recessions

This table compares the performance of ten sectors during the bear markets that accompanied the last two recessions. The numbers show the percentage return of each sector compared to the overall market (which was down), not the absolute return of the sector. Numbers in parenthesis are negative.

	BEAR MARKET STARTING IN	
SECTOR	2000	2007
Consumer staples	78.1%	26.6%
Utilities	4.4%	12.4%
Health care	43.3%	17.3%
Telecommunications	(25.3%)	7.6%
Energy	33.6%	9.9%
Consumer discretionary	7.4%	(1.5%)
Financials	25.8%	(26.4%)
Information technology	(34.9%)	3.0%
Materials	27.3%	(2.8%)
Industrials	11.5%	(8.4%)

Source: Singer, "Positioning Portfolios for the Eventual Bear Market," Trusts & Estates (September 2018)

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No contest?

How can one be confident that one's will won't be challenged by an unhappy heir? One approach is with a *no-contest provision,* also called an *in terrorem* or *forfeiture* clause. It provides that a beneficiary who contests the will loses at least some, and typically all, of the benefits given under the will. In terrorem provisions are one of the most frequently used contest prevention techniques. This widespread use is due to the technique's low cost (a few extra lines in the will), low risk (no penalty incurred if the clause is declared unenforceable), and the potential for effectuating the testator's intent (property passing via the will rather than through intestacy or under a prior will).

Most states uphold forfeiture provisions. However, even if in terrorem provisions are valid and enforceable, they tend to be unpopular with the courts and so are strictly construed. Courts avoid forfeiture unless the beneficiary's conduct comes squarely within the conduct that the testator prohibited in the will. Courts sometimes treat the beneficiary's suit as one to construe or interpret the will, rather than as one to contest the will, to avoid triggering a forfeiture.

For a no-contest provision to deter a will contest effectively, it must be carefully drafted so as to place the disgruntled beneficiary at significant risk. If a testator leaves nothing or only a relatively small amount to the heir he or she wishes to disinherit, a no-contest provision will have little impact because the heir gains tremendously if the will is invalid and loses little if the will and accompanying no-contest provision are upheld. Assume that an heir would receive $100,000 under intestacy and $5,000 in the will. The heir is likely to risk a sure $5,000 for a potential $100,000. However, if the testator leaves the heir a substantial sum, e.g., $50,000, the heir will hesitate to forfeit a guaranteed $50,000 for fear of taking nothing if the will is upheld, even though the heir would receive a $100,000 intestate share if the will is invalidated. And, of course, the heir would not really receive $100,000 because most attorneys take will contest cases on a contingency basis, so the heir is likely to net only about $65,000. Most people in the heir's position would think long and hard before risking $50,000 for $65,000.

The testator should name an alternate recipient of the property that is subject to forfeiture under a no-contest provision. This provides someone with a strong interest for upholding the will and the forfeiture provision. This contingent beneficiary, especially if it is a large charity able to elicit the support of the state's attorney general, may be able to place significant resources into fighting the contest.

Don't explain

An explanation in the will of the reasons motivating particular dispositions may reduce will contests. For example, a parent could indicate that a larger portion of the estate is being left to a certain child because that child is mentally challenged, requires expensive medical care, supports many children, or is still in school. If the testator makes a large charitable donation, the reasons for benefiting that particular charity may be set forth along with an explanation that family members have sufficient assets of their own. The effectiveness of this technique is based on the assumption that disgruntled heirs are less likely to contest if they realize the reasons for receiving less than their expected share.

It is possible, however, for this technique to backfire. The explanation may upset some heirs, especially if they disagree with the facts or reasons given, and thus spur them to contest the will. Likewise, the explanation may provide the heirs with material to bolster claims of lack of capacity or undue influence. For example, assume that the testator's will states that one child is receiving a greater share of the estate because that child frequently visited the aging parent. Another child may use this statement as evidence that the visiting child unduly influenced the parent. If the explanation is factually incorrect, heirs may contest on grounds ranging from insane delusion to mistake or assert that the will was conditioned on the truth of the stated facts.

An alternative approach for testators insistent on discussing their motivation is to provide explanations in a separate document or audio/video recording that could be produced in court if needed to defend a will contest, but which would not otherwise be made public. ☐

Moving expense reimbursements

One of the casualties of last year's Tax Cuts and Jobs Act was the elimination of tax-free employer reimbursements for moving expenses. However, the legislative language contained an ambiguity. The effective date for the change was January 1 of this year. Did that mean for reimbursements made after that date, or for actual moves after then?

Noting the uncertainty, the IRS in September called this one in favor of the taxpayers. That means employer reimbursements paid in 2018 may be tax free if they concern moves that happened in 2017. This treatment does not apply if the taxpayer claimed a tax deduction for expenses already.

The IRS Notice also provided a procedure for employers to recover any employment taxes that they may have paid in this situation.

Learning about taxes

Brad and Betsy Ray created the National Home Education Research Institute, a nonprofit organization. NHERI employed Brad, but it did not pay him a salary because it was short of funds. Its funding came from donations and book sales. Brad also gave speeches and did consulting work with respect to home schooling.

Although the organization could not pay Brad, it did provide payments to the couple's six children for their work as office assistants. However, no record was kept of the hours that the children worked or what specifically they achieved. The wages were not reported to the IRS. None of the children filed tax returns. Neither did their parents.

Initially, the IRS examined the Rays for 2010, but that was later expanded to cover 2006 through 2011. The Rays filed late returns for those years in 2012. Over that time frame, according to an IRS analysis, the Ray children received some $260,000 in payments, which were deposited into an account for household expenses.

In paying himself instead of his children, Brad was attempting to assign his income to them, the IRS argued, and the Tax Court agrees. Given his control over the account to which the children's "earnings" were deposited, it is clear that Brad was the true earner of the income.

What's more, Brad and Betsy failed to report some of their income from speeches on their tax returns. The Rays were hit with a penalty for failure to file their tax returns when the Court ruled that there was no reasonable cause for the failure. An accuracy-related penalty was also assessed for their substantial understatement of income. The total tax deficiency came to $151,739, and the penalties tacked on an additional $58,204. ☐

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