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Trust UPDATE

April 2013

Investment management during an interest rate drought

In particular, the Committee indicated that it expected that the exceptionally low range for the federal funds rate would be appropriate at least as long as the unemployment rate remains above 6½ percent, inflation between one and two years ahead is projected to be no more than ½ percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

—The Federal Reserve's *Monetary Report to the Congress*, February 26, 2013

Translation: Short-term interest rates will stay near zero until unemployment falls to 6.5%. Most forecasters expect that won't happen sooner than 2015.

This has been an unprecedented period of low interest rates. The squeeze is especially difficult for investors who had relied for their income on higher-interest rate bonds or CDs obtained years ago. As those instruments mature, they are finding few reinvestment opportunities that match their risk/reward profile.

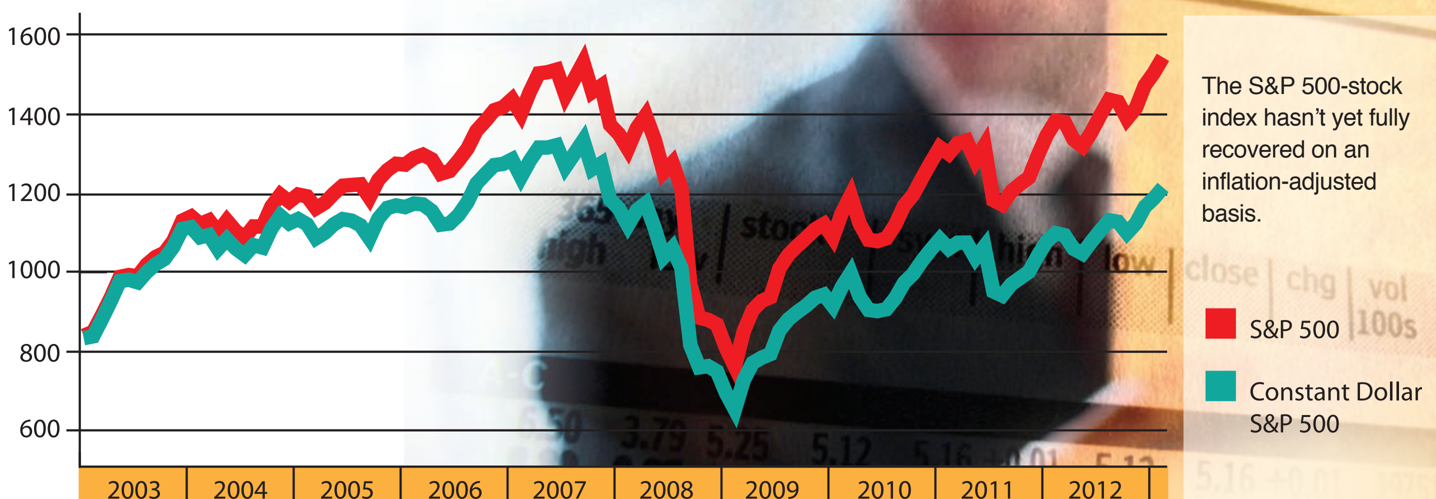
Sustained low interest rates may have contributed to the run-up in stock prices. The Dow Jones Industrial Average broke through its all-time high in early March. However, as the graph below shows, prices have further to go to make up for inflation.

Meeting the investment challenge

Many of our new investment or living trust clients are concerned about investing in this unfamiliar climate. How can they invest their capital to generate more income, without running unacceptable risks?

Create a safety net. The first step toward meeting that challenge, we believe, is to set aside an adequate reserve fund. Granted, today's short-term interest rates look puny by past standards. Nevertheless, it's wise to have sufficient cash reserves to meet six months' expens-

Stock market recovery



Source: M.A. Co.

es, even a year to be extra cautious. This reserve fund also should include enough to meet any special family expenses—such as college tuition—expected within the next few years.

The point of the safety net isn't only to provide rescue when needed, it also gives one the confidence to take risks that might otherwise be unacceptable. It allows some remaining portion of the portfolio to be committed for a longer term, without the fear of premature liquidation.

Diversify. The second step is to map out a diversified, long-term investment program for the balance of the investable assets. "Diversified" usually means putting money into stocks as well as bonds, and into international securities as well as domestic ones. Why? For at least three reasons:

1. Although the market values of both bonds and stocks fluctuate from day to day and year to year, the fluctuations do not always parallel each other. As a result, a long-term investor who owns good-quality stocks as well as investment-grade bonds actually may run less market risk overall than an investor who puts everything into bonds.

2. Interest income from a bond remains the same, year after year. Dividends from good income stocks tend to be lower to start with but can be expected to grow over the years, especially as an economic recovery takes hold. That's a major plus, especially when you consider the potential for inflation in our future.

3. U.S. stocks no longer dominate the world markets as they once did. Much of the world's future economic growth is expected to occur outside of the U.S.

What if income isn't enough?

One need not confine oneself to the shortest-term investments in order to build a measure of safety into a portfolio. A program of staggered maturities for bonds, for example, can add more income from the longer end of the yield curve. However, the longest maturities are accompanied by the risk of paper losses if long-term interest rates move upward. As a rule, the more distant a bond's maturity date, the more severely its market value will fluctuate in response to changes in interest rates.

Investors who need additional cash flow have no alternative but to dip into principal. There's a right way and a wrong way to do it.

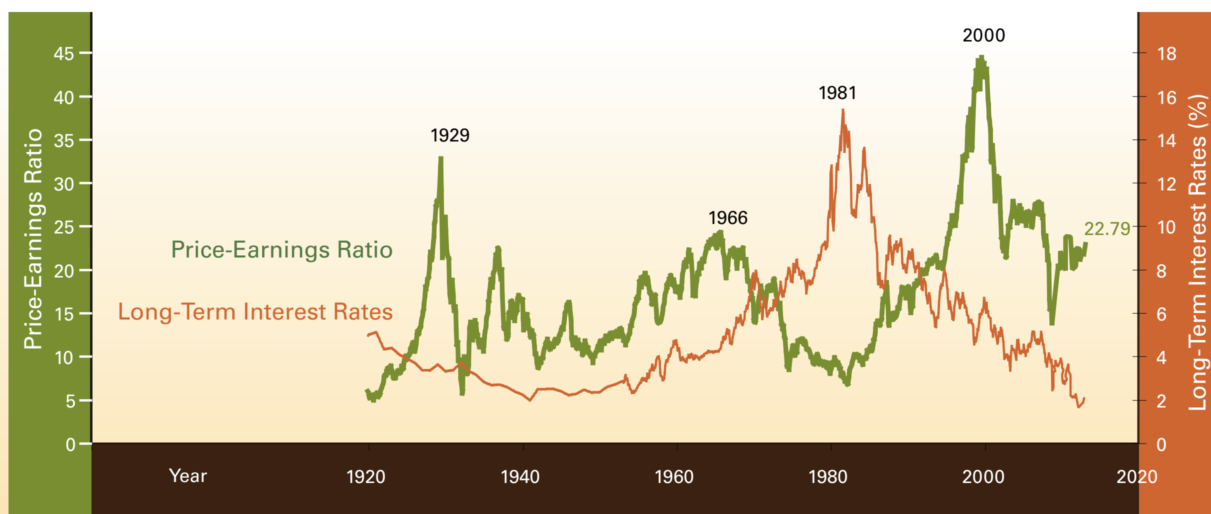
The wrong way is to risk money on shaky investments offering excessively high or remarkably regular yields. When these dubious ventures fail, investors may lose everything.

The right way is to stick to prudent investments, then supplement income with a planned program of limited capital withdrawals. For instance, one retiree looked up her life expectancy, doubled the number of years, and now has started a withdrawal program that won't exhaust her assets until the end of that period.

Call on us

As a trust institution, we've provided prudent investment supervision for family funds from year to year and generation to generation. Our experience and insights are at your service. At your request, we'll be glad to meet with you in person and discuss your investment needs. ☐

Earnings and interest rates



Source: M.A. Co. Data: http://www.econ.yale.edu/~shiller/data.htm

One important measure of investor sentiment is what they are willing to pay for a stream of company earnings. This is commonly referred to as the price/earnings ratio. This graph charts from 1920 to February 2013 the aggregate P/E of the large companies represented by the Standard & Poor's 500-stock index. Over the long term, the average P/E has been 15.5. As the Roaring 20s began, the P/E stood at just 5.8. A mania for stock investing drove the ratio to a peak of 31.48 in 1929, just before the great crash. That kind of investor exuberance was driven from the market for about 70 years, until the late 1990s and the Internet investment bubble.

In the early 1980s, when stocks were extremely unpopular, the P/E ratio fell to single digits. It wasn't just the riskiness of stocks that drove investors away, it was the alternatives. Long-term interest rates on safe government bonds rose to an unprecedented 15% in 1981. Why take a chance on a company when guaranteed double-digit returns are available?

We may be experiencing the flip side of that thinking now, as interest rates remain low for such a sustained period.

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Taxes come first

Here's a true story for tax-filing season. George Thompson owed substantial back taxes and penalties to the IRS, over $100,000. He proposed a program of monthly payments of $3,000 to meet his obligation, but the IRS believed that he could pay much more. George's counsel filed Form 433-A showing monthly income of $27,633 ($331,596 annually) and monthly expenses of $24,416. The difference was the amount that George offered to pay. The Service challenged two specific items of expense as not allowable in this computation.

Tithing

As a member of the Church of Jesus Christ of Latter Day Saints, George was required to tithe, paying $2,110 to the Church each month. He felt that this payment was not discretionary, citing the Bible, and the Tax Court responded in kind in its opinion:

> Petitioner introduced evidence, including a biblical passage from the Old Testament, to support his position. See Malachi 3:8-10. This brings to mind another biblical passage suggesting an answer to this type of dilemma: "Render therefore to Caesar the things that are Caesar's, and to God the things that are God's." Matthew 22:21.
>
> However, even this formulation presents the dilemma of determining which things fall into the two respective categories.

George advanced three arguments that his tithing was not a conditional expense, and so it needed to be allowed by the IRS. First, George held a number of offices in the Church, and his tithing was a prerequisite to holding those offices. The IRS Manual does allow for considering tithing an allowable expense, but only when it is pursuant to paid employment, the Tax Court held, not volunteer offices.

Next, George protested that his spiritual health and welfare would be adversely affected if he could not tithe. The IRS Manual does include an allowance for health and welfare, but that does not extend to spiritual health. Indeed, "it would generally be inappropriate for the Commissioner or this Court to make determinations concerning what is or is not necessary for a particular person's religious or 'spiritual' health or welfare."

Finally, George claimed that interfering with his tithing violated his religious freedoms under the First Amendment. If he cannot tithe, he will lose the various offices he holds in the Church. That is the Church's decision to make, the Tax Court held, not the government's. Indeed, the First Amendment forbids the government to participate in the decision of what offices Church members may hold. But it does not forbid the government from insisting that taxes be paid before charitable contributions are made.

College expenses

George also had monthly college expenses of $2,952. He believed that the IRS should have also allowed this expense as necessary.

The IRS Manual does address this situation. It provides that if the plan for paying off the tax debt will be completed within five years, the college expense will be allowable; otherwise it will not be. George's plan to pay just $3,000 per month would not have paid off his back taxes and penalties within a five-year period, so the Tax Court rejected his plea.

The better course

On the one hand, it is good to know that the IRS will allow taxpayers to satisfy their debts over time. On the other hand, how could a taxpayer, even one with so large an income, fall so far behind on paying his taxes?

See your tax advisors to be confident that this doesn't happen to you. ☐

ESAs are permanent

For those who are accumulating funds for a child's or grandchild's education expenses, there was good news in the American Taxpayer Relief Act of 2012, which was passed to avoid the "fiscal cliff" as the year started. The tax code provisions for the Coverdell Education Savings Account (ESA) were made permanent. These accounts may be an alternative to or a supplement to a 529 college savings plan.

Contributions to an ESA are not tax deductible, but there is no tax as the income builds up in the account. Distributions from the ESA are tax free if they are used for qualified education expenses, which may include room and board if the beneficiary is enrolled on a half-time or greater basis.

ESAs have two advantages over 529 plans. First, qualified expenses are not limited to higher education, as with the 529 plan, but may also include tuition at private school as early as kindergarten. Second, where 529 plans are typically limited to just a few investment choices, with the money managed by the plan sponsor, there are no similar limitations for ESAs.

However, there are two ESA disadvantages to consider also. Most important, no more than $2,000 per year per student may be contributed to an ESA. Second, contributions must end when the beneficiary reaches age 18. Therefore, no more than $36,000 total may be set aside for one student, which almost certainly will fall far short of the financial need. Still, having a dedicated capital source that is growing tax free as one begins higher education is nothing to sneeze at.

Contributions to ESAs are not permitted for those whose income is too high—modified adjusted gross income of $110,000 for singles, $220,000 for a married couple. In that case, an outright gift may be made to the child, and the child may contribute to the ESA.

Successor beneficiaries

What if the beneficiary decides against college? The ESA accumulation may be rolled into another ESA for a family member of a beneficiary. The new beneficiary must be of the same or higher generation as the original beneficiary. What if the beneficiary dies or is divorced? The ESA may be rolled into a successor ESA for the surviving or ex-spouse of the beneficiary, with the tax deferral intact.

The ESA must be distributed by the time the beneficiary reaches age 30, or within 30 days after that date. The distribution may be in the form of a rollover to another family member. Amounts not rolled over and not used for qualified expenses are included in taxable income, and a 10% tax penalty applies. ☐

In today's financial markets, investing for income poses real challenges. Interest rates are very low, and all dividends are not created equal.

If you would like help with the management of your portfolio, come talk with one of our investment professionals.

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