

**Investment management**

Level-headed investing  
Our services for  
level-headed investors  
What's the duration?

**Tax currents**

A new, easier  
home office deduction

# Trust UPDATE

**Stillman**  
BANK

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## Level-headed investing

The emergence of the field of “behavioral economics,” the academic study of why we handle money the way that we do, has been of great interest to investors. It's been observed that smart people sometimes make terrible money management decisions, and perhaps emotions can account for some of this apparent irrationality. Knowing this fact, perhaps the rational investor can do better by staying alert to emotional miscues.

Then came the field of “neuroeconomics,” which suggested that some of our money management techniques are hard-wired into our brains. *Money* magazine editor Jason Zweig summarized the findings of both these fields in his 2007 book, *Your Money and Your Brain* (Simon & Schuster). Among the early observations about how the brain responds to economic stimulus:

- the anticipation of a gain and the receipt of that same gain are processed in two different parts of the brain;
- financial losses are processed in the same area of the brain that responds to mortal danger;
- money gains and losses produce tangible, biological changes in the body, not just psychological ones;
- expecting an event (whether good or bad) is often more intense than experiencing that same event;
- someone who is making money from investments has neurological activity that cannot be distinguished from someone who is taking cocaine or morphine.

The most practical discovery, however, may be that the brain tends to look for patterns. There is a natural urge to try to make predictions about the future, even when the available data are simply random. Uninformed guesswork should be resisted, because it can lead to poor investment decisions.

### **Mood swings**

Researchers have discovered that they can materially affect the financial judgment of their subjects by altering their environment.

- Which would you choose, a 70% chance of winning \$2 or a 4% shot at \$25? The long shot is the riskier choice, given that there's a 96% chance of coming up with nothing. When one group of students was shown TV comedy skits before being asked to make that





## Our services for level-headed investors

**We tailor our offerings to the individual needs of our clients.**

**Investment management accounts.** We'll help identify your goals and map out a personal investment strategy, utilizing asset allocation models to optimize risk and reward. Then we'll create a diversified portfolio, including stocks, bonds and cash, that is consistent with your objectives, income needs and risk tolerance. You'll receive regular progress reports.

**Revocable living trust.** A trust is similar to an investment management account, with several pluses. Plus full financial management in the event of your incapacity. Plus probate avoidance. Plus protection of your beneficiaries beyond your lifetime.

**IRA rollover.** You can defer income taxes on a lump sum distribution from a qualified retirement plan by arranging for a rollover of the money directly to an IRA rollover. The usual IRA rules will apply. Our asset management specialists can help you to develop an IRA investment program that makes the most of tax deferral, while dovetailing with your other investments.

### **Level-headed investing . . . continued**

choice, 60% went with the safer approach, the one with the lower reward. The other group didn't watch TV. They were required to sing Frank Sinatra's "My Way" *a capella*. Twice. Their mood upon completion of the task was so different that 87% of them chose the long shot.

- Can you name three factors that might increase your risk of heart disease? Can you name eight? What is your own risk of developing heart disease? Men who were asked to name three factors rated themselves at higher risk than those who were asked for eight factors. Researchers speculate that with just three risk factors, the risk is more concrete and easier to visualize, more real. Eight factors are harder to come up with. With eight risk factors, the person may well have thought that he doesn't fit the profile very well.

### **The alternative: asset allocation planning**

Contrary to the belief of some investors, the key to successful investing isn't picking the best stock, and it isn't jumping in and out of the market, guessing at the peaks and the valleys. The better course is to invest for the long term with an *asset allocation plan* that optimizes risk and reward. With a balanced portfolio approach to asset management, one can get much of the potential gain that the market offers, while keeping the potential for loss to an acceptable minimum.

As you assess your own investment portfolio, keep these points in mind:

- **Look at your whole portfolio.** Don't focus on extremes, the winners and the losers. Total portfolio return is the target. Sound diversification among and within asset classes is the key to steadier returns.
- **Reduce your risk as your time horizon shortens.** As you approach retirement or other key dates for tapping into your portfolio, you may want to reduce your exposure to riskier securities. Still, remember that retirements last a long time, and you need some inflation protection.
- **Don't expect history to repeat itself.** Comparing the stock market today to earlier periods will not prove helpful in making investment decisions. The time in which we live is unique, and our responses to the opportunities and challenges that lie ahead must be guided by today's realities, not past cycles.

### **Let us help you**

Finding good help for investment management is no easy matter. It's a bit like selecting a doctor or a lawyer. You have to find someone you can trust, someone with whom you feel comfortable.

That someone should be us. We offer unbiased investment advice, designed with your needs and those of your family in mind. We utilize a team approach to investment and financial management, with professionals from a range of disciplines to provide you with a complete financial management solution.

If you haven't yet taken advantage of our services for investors, we invite you to make an early appointment to learn more about our offerings. □

# What's the duration?

Bond investors were unsettled earlier this year when Fed Chairman Ben Bernanke suggested that the Federal Reserve might begin scaling back bond purchases sooner than expected. That led to a jump in the 10-year Treasury bond yield to 2.7%. Because bond prices move in the opposite direction of interest rates, the value of bond funds fell 7.5% from early May through early July, according to Morningstar, Inc. Skittish investors pulled some \$81 billion from fixed-income mutual funds and ETFs in June, *The Wall Street Journal* reported.

Investors generally think of the stock portion of their portfolios as the volatile component, but in today's low-interest-rate environment, bonds need close attention as well.

## Measuring the risk

Just how much will a given change in interest rates affect the value of a bond in your portfolio? That depends on several factors, including the time to maturity and the difference between prevailing interest rates and the rate at which the bond was issued. (Bonds trading at a discount to their face value will swing more sharply than comparable issues trading at a premium.)

A measure that takes all the relevant factors into consideration is a bond's duration or the average duration of a bond fund or individual portfolio. Derived by a complex formula, duration is the average of the present values of a bond or bond portfolio's cash flows weighted by the time remaining until they are payable. Duration can be quite useful in estimating market risk—providing a close approximation of the effect of changes in interest rates on a bond's value:

- If a 20-year bond's duration is 12, you know that a change of 1% in interest rates will cause the bond's price to rise or fall approximately 12%.
- If an intermediate-term bond fund has a duration of 3.5, that 1% change in interest rates will raise or lower the fund's share price by about 3.5%.

A bond's duration also can help an investor compensate for reinvestment risk. Although a rise in interest rates lowers a bond's market value, it also gives an investor a higher yield on reinvested interest payments. Likewise, lower rates raise bond values but reduce reinvestment yields.

A bond or bond portfolio's duration approximates the time in years at which the price change from a change in interest rates will be balanced by the increased or decreased return from reinvestment. Thus, by matching a bond investment's duration to the time at which you will have need of the proceeds, you can be fairly certain that your total return will meet your expectations.

## When will rates rise farther?

As the Fed winds down its stimulus, bond yields would be expected to rise to more normal levels of 3.5% to 4%. No one knows when that will happen, and few expect it to be this year. The economic recovery remains too fragile, and unemployment remains too high, for the stimulative effect of low interest rates to be withdrawn. On the other hand, if inflation begins to creep into the economy, the options for monetary policy may become more limited.

## Choices for investors

Ideas that bond investors may want to look at, or discuss with their advisors, include:

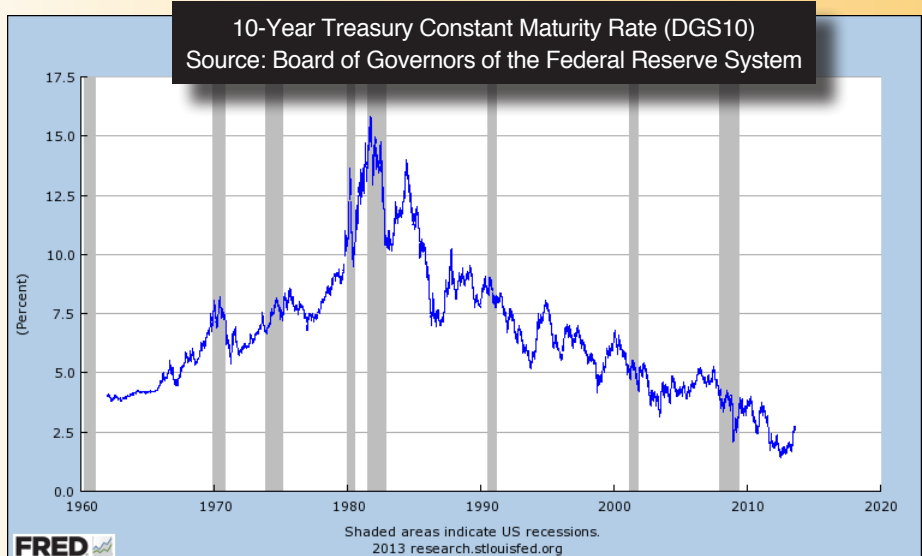
- moving to shorter-term bonds to reduce interest rate risk and the duration of the bond portfolio;
- diversifying to bonds that are sensitive to factors other than interest rates. For example, investors in high-yield corporate bonds usually are most concerned about credit quality. If interest rates go up generally because the economy is doing better, that suggests that the risk of default in higher-yield instruments will be going down, preserving their market value.

## Would you like a professional review of your holdings?

Managing fixed-income portfolios is an important part of our everyday business. We would be happy to share our investment insights with you and cast our professional eye on your portfolio. If you are interested, call us soon to arrange for a meeting at your convenience. □

## Context

Current low interest rates on 10-year Treasuries continue a downward trend that began after the back of 1970s-era inflation was broken.



## A new, easier home office deduction

Beginning in the 2013 tax year, the IRS has given taxpayers a choice when it comes to the home office deduction. To avoid the necessity of detailed recordkeeping, a new “safe harbor” deduction has been created for home offices. The deduction has been set in 2013 at \$5 per square foot of the home office space, up to a limit of \$1,500 (300 square feet).

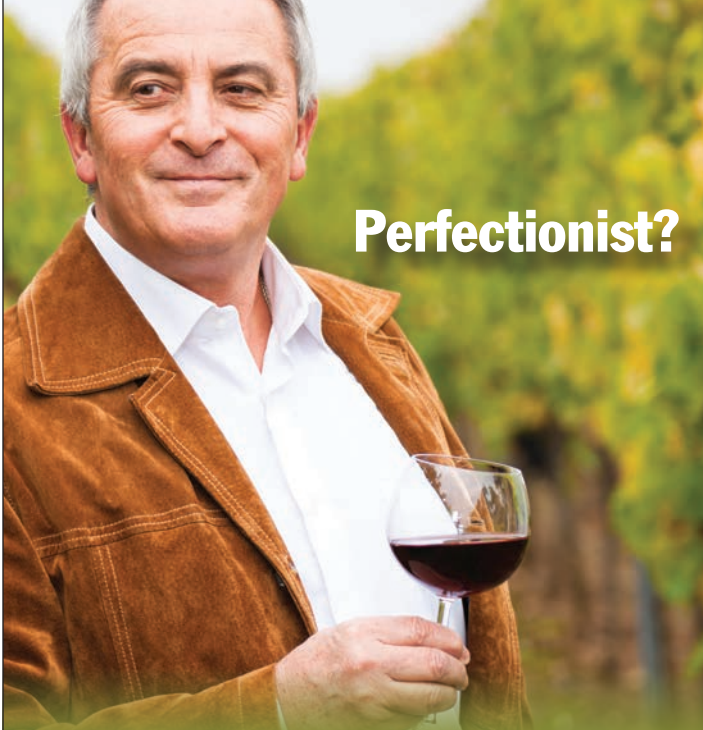
The existence of the new safe harbor and relief from recordkeeping does not change the other requirements for taking the home office deduction. The office must be used regularly and exclusively for business. The office should either be the principal place of business or used for administrative or management activities when the taxpayer has no other office for handling those chores. An office kept for the convenience of the employer, such as a salesman who lives away from company headquarters might have, also will qualify.

In many cases, the actual expenses for the home office will be greater than the safe harbor. These may include, for example, a share of utilities and insurance costs. The IRS has reported that for the 2010 tax year, the average home office deduction was \$2,600, so many people will find the safe harbor limit too low. The taxpayer may choose the traditional route of actual expenses instead of the safe harbor. What’s more, that choice may be made for each tax year, without regard to the choices made in earlier years. Thus, the taxpayer may alternate between methods, choosing the one most favorable each year.

With the traditional method of calculating the deduction, a proportionate depreciation deduction is permitted for the office space. The amount of the depreciation is recaptured and taxed as income when the house is later sold. The safe harbor alternative does not generate depreciation recapture.

The deduction for the home office may not exceed the net income of the business. If the business is showing a loss for the year, the loss may be carried forward when the traditional method of calculating the deduction is used. However, the carryover is not permitted with the safe harbor approach. What’s more, any carryover loss created from the actual home office expense calculations may not be deducted in years in which the safe harbor is elected.

Although the new provision is intended to make life easier for taxpayers, the reality is that many taxpayers will have to figure the deduction both ways to decide which is the better way to go. The lives of tax preparers just got more complicated. □



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**“When I learned about ‘fiduciary duty,’ I could settle for nothing less.”**

An investment advisor may be product centered, or client centered. Fiduciaries, such as us, are the ultimate client-centered advisors.

May we tell you more?



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