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Trust UPDATE

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How much in stocks?

That depends upon your time horizon

The current bull market for stocks is now more than six years old. By historical standards, that's unusual, perhaps remarkable. That has many investors wondering whether it's time to reduce their exposure to equities. Could the market be heading for a correction?

Over the last 89 years, the Standard and Poor's 500-stock index of large cap funds has turned in a positive performance 73% of the time, about three years out of four. The inherent risk and volatility of the stock market can be mitigated by diversifying the portfolio into bonds, or by having a longer time horizon to permit portfolio recovery.

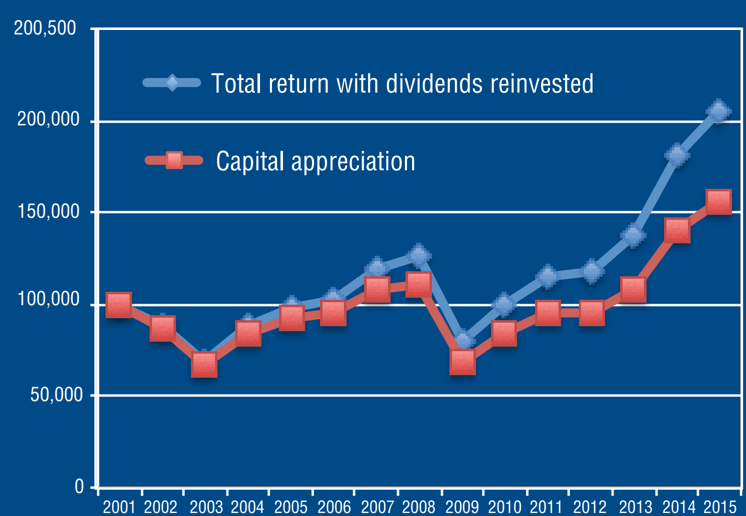
For example, a portfolio consisting of 30% stocks and 70% long-term government bonds has had a positive return 81% of the time, about four years out of five. If stocks are held for five years, they've been in positive territory 86% of the overlapping five-year periods. A portfolio allocated 30% to stocks and 70% to bonds has never had a negative five-year return. These calculations are drawn from the *Ibbotson SBBI 2015 Classic Yearbook*.

More to the story

Investors cheer upon news that the Dow Jones Industrial Average or the S&P 500 has set a new record high. But that is only part of the story. The price change of a stock is only one part of its total return. Dividends represent the income element of owning shares of stock. If the dividends are reinvested in stocks, there is a significant compounding effect. In part that's because dividends remain roughly constant, so that when stocks fall in price, an investor who is reinvesting dividends is buying more shares. That leaves him or her well positioned for the next upward price move.

The graph below looks at a hypothetical portfolio of 100% large-cap stocks, represented by the S&P 500. The timeline begins in 2000, just before the bursting of the Internet bubble and accompanying collapse in stock prices. It necessarily includes the meltdown of the financial services industry in 2008. Despite enduring those

The importance of dividends



A 2000 portfolio of $100,000 worth of the S&P 500-stock index would have grown to $155,940 by the end of 2014. Had all dividends been reinvested, the portfolio would have gained nearly an additional $50,000, reaching $205,154.

Source: M.A.Co. Data: *Ibbotson SBBI 2015 Classic Yearbook* two bear markets, $100,000 in large-cap stocks would have grown, over the next 15 years, to over $150,000. Had dividends been reinvested throughout the period, the investor's wealth would have grown to over $200,000.

The Last Ten Years of Stocks and Bonds on page 2 shows in more detail the components of total returns that investors have experienced.

Asset allocation

Looking back at 89 years of financial market history, the *Ibbotson Yearbook* reports that compound annual return from stocks has been 10.1%, while the compound annual return from long-term bonds has been just 5.7%. The reward for accepting the lower bond return is less volatility from year to year. Blended portfolios performed as follows:

90% stocks/10% bonds	9.9%
70% stocks/30% bonds	9.2%
50% stocks/50% bonds	8.4%
30% stocks/70% bonds	7.4%
10% stocks/90% bonds	6.3%

These returns assume that the portfolio is rebalanced each year. That is, when stocks outperform bonds, overweighting the portfolio to equities, stocks are sold and new bonds purchased, to maintain the desired blend.

If rebalancing is not done, the portfolio return will be higher, which is as expected, given that the portfolio risk is increasing. For example, the 50/50 portfolio jumps nearly a full percentage point, from 8.4% to 9.3% annually, if it is never rebalanced. However, without rebalancing at the end of the period, the portfolio will be 97.6% in stocks!

When we look at the data by decades, the all-stock portfolio is the best performer, with the exception of the 1930s, the 1970s and the 2000s. Over the last ten years, a portfolio of 50% stocks and 50% bonds was best, with an annual compound return of 8.2%, compared to 7.7% for all stocks and 7.5% for all bonds.

How is your portfolio doing?

What are your most important investment management worries? Stock prices? The effect that rising interest rates will have on bonds? The strength of the economy? Constructing a sustainable retirement income? The ripple effects that problems in other countries have on the global economy? Tax efficiency? Something else?

Whatever your concerns, we would be pleased to put our investment expertise to work for you and your family. Why not make an appointment to meet with us this month? ☐

The last ten years of stocks and bonds

	Large-cap stocks				Long-term government bonds			
	Capital appreciation	Income return	Reinvestment return	Total return	Capital appreciation	Income return	Reinvestment return	Total return
2005	3.00%	1.84%	0.07%	4.91%	3.02%	4.69%	0.10%	7.81%
2006	13.62	2.01	0.17	15.79	-3.64	4.68	0.15	1.19
2007	3.53	1.96	0.00	5.49	4.69	4.86	0.33	9.88
2008	-38.49	1.92	-0.43	-37.00	20.50	4.45	0.93	25.87
2009	23.45	2.48	0.53	26.46	-18.25	3.47	-0.12	-14.90
2010	12.78	2.02	0.26	15.06	5.89	4.25	0.00	10.14
2011	0.00	2.13	-0.01	2.11	23.74	3.81	0.68	28.23
2012	13.41	2.50	0.10	16.00	0.88	2.40	0.02	3.31
2013	29.60	2.48	0.32	32.39	-14.83	2.86	0.61	-11.36
2014	11.39	2.16	0.14	13.69	20.17	3.33	0.36	23.87

Source: M.A.Co. Data: *Ibbotson SBBI 2015 Classic Yearbook*

Over the last ten years, large-cap stocks had only one year of negative returns, but it was a whopper, a loss of 37% in 2008. Long-term bonds have been nearly as volatile as stocks in this period, with total returns ranging from a gain of 25.87% in 2008 (as investors fled the stock market) to a loss of 14.90% the following year. Note that the gap in income returns of stocks and bonds has narrowed in recent years.

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Living trusts and bankruptcy

In the usual case, you cannot employ a living trust as a mechanism to protect your own assets from your creditors. However, you may provide such protection for legacies for your heirs with a properly drafted trust. Trust assets may be out of reach if the heir declares bankruptcy, becomes divorced, or has some other financial calamity. A "spendthrift clause" may be used to achieve this objective. It puts full discretion over trust distributions in the hands of the trustee.

In the unusual case, living trusts may yet provide another layer of protection.

Unusual facts

Faith Campbell created a living trust worth $1.8 million for the benefit of her four children, one that included a spendthrift provision. The trust was to terminate after Faith's death "upon the settlement of her estate." Faith died in 2011.

One of Faith's grandchildren was the trustee of her trust. One child, Linda, was in financial difficulty resulting from the last recession. After Faith died, before her estate was settled, Linda wrote to the trustee suggesting that he exercise his discretion allowed under the trust. He took the hint and placed her share in a Merrill Lynch account, for which he continued to be the trustee. Distributions to the other children from the living trust continued as before.

A month later, Linda declared bankruptcy. She included her trust interest in her bankruptcy petition, but noted that she was simply a discretionary beneficiary subject to the spendthrift clause. The bankruptcy trustee challenged that characterization and sued Linda for her share of the trust's assets. He also characterized the creation of the Merrill Lynch account for her as a fraudulent transfer.

The Bankruptcy Court agreed. The Court also was concerned that the trustee of the spendthrift trust was Linda's nephew. In its decision on the case, the Court worried that the trustee simply would follow Linda's instructions, which gave her effective control of the money. The Court ruled against Linda on every issue.

Reversed on appeal

Linda appealed the Bankruptcy Court's decision to Federal District Court, which found in her favor. The key to the District Court's reasoning is that by its terms the living trust had not yet terminated, because Faith's estate had not been finally settled. Considerable work may be required to settle an estate. Until that work is finished, trust administration was required, which gave continued life to the trustee's spendthrift powers. Linda had not yet acquired a property interest in the trust that could be included in her bankruptcy estate.

Linda received an extra layer of financial protection from her mother's living trust by an accident of timing, the fact that her bankruptcy occurred before the trust reached its termination point. Her mother could have deliberately provided for such creditor protection for the inheritance for Linda or for all of her children by having the living trust continue for the children's lives. Her single trust could have been divided into four continuing trusts, one for each beneficiary. If the successor trusts also included spendthrift provisions, creditor protection could have lasted a lifetime.

On the other hand, adult children may prefer unfettered access to their inheritance. They may feel uncomfortable making their case to the trustee each time that a substantial trust distribution is wanted. They may harbor the feeling that the parent did not trust them with the family fortune.

The balance needs to be struck by the trust grantor. If the long-term asset protection plan is selected, the benefits and burdens should be explained carefully to all beneficiaries, to avoid misunderstandings and litigation later. ☐

401(k) plans cross a tipping point

From their modest beginning in 1978 as a supplemental tax-deferred retirement savings plan—known in those days as "cash or deferred" or "salary reduction" plans—the 401(k) plan has grown to be a cornerstone of retirement security for millions of Americans. By 2000 there was some $1.7 trillion managed in these plans. Growth continued since then, powered by both strong financial markets and growing annual contributions by employees, especially baby boomers in their peak earning years. By the end of 2014 the aggregate holdings of 401(k) plans totaled $4.6 trillion.

However, that figure may prove to be a high water mark. *The Wall Street Journal* reports that in 2013 there was a net outflow of $11.4 billion from these plans. Baby boomers are retiring—another 3.5 million may do so this year. As they do, they begin to draw down their accounts to meet living expenses. Some portion of retirees roll their entire account balance over into an IRA to preserve preferential treatment for their retirement capital.

Net outflows are projected by analysts to increase to over $50 billion by 2019. The shrinking of the 401(k) pie may encourage more competition among those who provide services to this market.

On the other hand, the millenials ought to start making their contributions toward their retirement soon—after their student loans are paid off. After all, many of them believe that Social Security is not likely to last as long as they will.

New life for participant claims

A group of employees sued their employer because they were dissatisfied with certain 401(k) investments that had been offered in their plan. The issue was not the performance of the investments, the problem was that they were offered "retail" shares instead of institutional shares that were available for the same mutual funds. The retail shares came with higher sales charges, which depressed the total return for investors.

Three of the funds were offered more than six years before the employees began their lawsuit. The relevant federal law, the Employee Retirement Income Security Act of 1974 (ERISA) requires that claims for damages be filed within six years. The lower courts held that the claims related to those three funds were too late.

On appeal the U.S. Supreme Court reversed in May, holding that the fiduciaries who manage a 401(k) plan have an ongoing duty to monitor the investments offered by the plan. The decision on whether the particular funds were prudent was referred back to the Court of Appeals. ☐

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