

# *Financial Security by Design*

*Investment and Estate Planning*

October 5, 2000

Reposted January 23, 2001

Dear Customers and Friends,

Market Performance. My baseline equity portfolio gained 14% for the year ending September 30. It has grown at an annualized 18% rate over ten years.

The portfolio value moves up and down about one percent on a typical market day. This is about the same as the price movements in the broad US market but only one third of the volatility of the NASDAQ 100 index.

Positioning Your Portfolio. Every investor needs to know the minimum investment return that they need to support their life style, what level of risk they are willing to undertake and how much in personal effort or fees they are willing to pay to manage their portfolio. Compromises may be necessary.

I have no incentive to adopt an investment strategy designed to outperform since the historical average returns are adequate for my needs and I do not get a psychological high when my portfolio outperforms the market.

Indeed, I am disinclined to try for above average returns since this means more volatility. I get a funny feeling when the market swoons and I don't like it a whole lot better when the market zips up. I'm also a lousy sailor and I never got fully comfortable piloting a small aircraft.

To smooth out the ups and downs, I don't buy individual stocks. Apple Computer lost 52% one day last week, for example. I also diversify among market sectors. For the year to date, the REIT component in my baseline portfolio is up smartly, US stocks are flat and the international component is down. Overall, however, the portfolio is down only one percent and day to day price movements have been smaller than for any individual component.

Another concern is being forced to take money out of an equity portfolio during a market decline. See "Controlling Risk" at [www.lingane.com/tax/risk.htm](http://www.lingane.com/tax/risk.htm). There is recent good news in that earnings are increasing. With prices flat, price earnings ratios are declining and this probably makes the market a little less risky than it was a year ago.

A market decline is only a temporary hiccup for younger investors but those who depend on investment income should maintain a bond portfolio large

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enough to pay for several years of living expenses. This way, they will have enough resources in stable investments to weather a serious market decline.

I don't re-allocate my portfolio in anticipation that a particular market sector will outperform in the immediate future. Dynamic asset allocation can boast investment returns slightly but is not justified for modest portfolios unless you are doing it for fun rather than as a return on your time and money invested.

I don't use investment newsletters and I don't have large positions in actively managed mutual funds. Above average managers are few and far between, less than half of the mutual funds beat the market averages in any given year and fewer still do so consistently, and it is essentially impossible to identify above average managers early in their careers. It does no good to buy Fidelity Magellan just before Peter Lynch retires!

The returns of successful managers can be less than they appear. Over the past ten years, Foster Friess's Brandywine and Ken Heebner's CGM Capital Management have delivered 591% and 537% cumulative pre-tax returns in an IRA account. The pre-tax return of the baseline portfolio, while extraordinary by historical standards, was 419%.

The baseline portfolio has only a small dividend since index funds don't usually buy and sell. Friess and Heebner buy and sell in their portfolios, though not excessively so, and produce larger dividends. If these funds were held in a taxable account, there would be tax on the dividends, this tax lowers the cumulative return and the effect is larger for Brandywine and CGM Capital because they pay larger dividends.

This analysis is not exact since I am neglecting differences in unrealized appreciation but calculations make it is clear that most of the extra returns achieved by Friess and Heebner are wiped out by lower tax efficiencies.

Then there is volatility. These funds were half again as volatile as the baseline portfolio over the past ten years. Brandywine produced negative returns about one fiscal year out of three and performance was flat in 1998 when the market was up strongly. CGM Capital Management was the top equity mutual fund in 1991 but was down 23% in 1994 and has underperformed recently.

I conclude that investors who back managers like Friess and Heebner can achieve better returns if the funds are held in pension accounts where tax inefficiencies do not matter. On the downside, an actively managed portfolio will be more volatile and it is a challenge to identify skilled managers early in their tenure. A passive strategy gives up the possibility of a home run but why risk a Hail Mary pass if average returns will achieve your financial goals?

Every investor needs to decide these issues for themselves. I suggest that you also compare your return and volatility to that of the baseline. If your return is lower or your volatility is higher and you have no explanation, consider a gradual shift of your portfolio into index funds. Call if you need assistance.

Treasury Inflation Protection Securities. The actively managed Harvard endowment fund has some of the best investment returns in the academic world. What caught my attention in a recent Barron's article was that Harvard's portfolio includes a billion dollars of inflation protected bonds.

The US government guarantees 4% income plus growth of principal to compensate for inflation. No equity portfolio can guarantee a 4% withdrawal, adjusted for inflation, through thick and thin. In addition, the price of TIPS is less affected by interest rate changes than is the price of other Treasury bonds because the government has assumed the inflation risk. TIPS are further discussed at [www.lingane.com/tax/tips.pdf](http://www.lingane.com/tax/tips.pdf).

With inflation currently running at 3.4%, long TIPS are returning 7.3% before tax or about 1.4% more than conventional Treasury securities. The Treasury's next auction of long TIPS has been announced for October 11. See <ftp://208.131.225.4/of/ofp100400.pdf> or call your broker.

It seems that the Bureau of Labor Statistics has been double counting rental units switched from individual to central air conditioning. This has understated the Consumer Price Index by about 0.1% recently. Read the full story at <http://stats.bls.gov/cpirev01.htm>.

This error effects TIPS in two ways. First, valuations were understated during the first part of this year. If you sold, you lost a little money; if you bought, you made a little money and, if you did nothing, the value of your portfolio will adjust to the correct valuation the revised CPI numbers get worked into the calculations. (Valuation adjustments lag the CPI by three months.) Second, the Treasury paid too little interest during the first half of the year, about a million dollars too little for each \$50 billion worth of TIPS in circulation.

Year End Actions. The fourth quarter is when we typically make portfolio adjustments to reduce tax liability, to rebalance portfolios and to replace cash spent during the year. Keep the following ideas in mind.

1. Mutual funds will make taxable distributions in the fourth quarter even though most funds will probably be down for the year. Contact the fund company for an estimate of the amount and timing of the distribution.

If you are planning to sell a fund, you can generally reduce your tax liability by selling before the distribution and it is usually best to delay substantial new investments until after the distribution.

These comments do not apply to funds held in IRA and pension accounts.

2. You can offset \$3,000 of net capital loss against other income. If your loss is larger than this, the extra is carried over to offset gains or other income in future years. So, if you are thinking of selling a losing fund, you might save income taxes this year by selling before year's end.

3. Many of us pay real estate and California income taxes and make charitable contributions in December so as to claim a deduction in the current year. This is not always the best strategy.

Consider a retired couple who pays \$6,000 in taxes and who makes \$3,000 in charitable contributions every year. Because the standard deduction is larger than the sum of their itemized deductions, annual contributions provide no tax benefit. If this year's contributions are delayed to January, next year's itemized deductions will be larger and there may be a tax benefit.

Watch for the alternate minimum tax. If you have exercised incentive stock options or if you have capital gains income, you might have to pay the extra AMT tax and you may be better off delaying California tax payments until January. Contact me for a year end forecast if you want to be sure.

4. When deciding how much cash you will need next year, don't forget to make provision for any Roth conversion that you did in 1998. Next year will be the final payment. After that, your tax bill should become more reasonable.

Tax Legislation. There have been no significant changes yet this year. Estate tax reform, marriage penalty relief and pension changes have gone nowhere.

The amount that we each can bequeath free of estate tax remains at \$675,000 until 2002. The \$10,000 annual gift tax exclusion is indexed for inflation but it is unlikely to increase before 2002.

Should you be interested in how the Bush and Gore tax proposals effect you personally, check out "Pocketbook Politics: How Tax Plans Would Affect You" by John D. McKinnon in the October 4, 2000 *Wall Street Journal*. The free online version at [www.wsj.com/taxes](http://www.wsj.com/taxes) includes an EXCEL spreadsheet.

Community Property With Right of Survivorship. Married couples receive a double step-up in basis for stocks and real estate upon the death of either spouse if the asset is owned as community property. The difficulty is that there may have to be a probate unless the asset is owned inside a living trust. Effective for transfers on or after July 1<sup>st</sup>, 2001, you can own California real estate as community property with right of survivorship; see AB 2913. This change allows a double step-up in basis without probate or a living trust.

California has a "transfer on death" registration for securities. This allows a double step-up in the basis of securities without probate or a living trust.

Since these are new provisions, expect difficulties with your broker or title company. A broker in Walnut Creek insisted that the transfer on death designation was not available for community property, for example.

I don't want to leave the impression that I favor CPWROS over a living trust. Even when probate is not an issue, a living trust makes it easier for someone else to manage your affairs if you become ill. But, if I were buying a home and had not yet finalized my living trust, I would record title as CPWROS.

Retirement Seminar. On Saturday morning, October 21 in Sunnyvale, the American Association of Individual Investors presents a three hour seminar "Post Retirement Lifestyle Planning Choices." Barbara Beck stole the show at a similar program a couple of years ago by demystifying living trusts and living wills. Her presentation alone is worth the \$15 fee. (408) 993-7517.

Securing Your Brokerage Information. I created an on-line account for one of my brokerage accounts using only my account number and Social Security number. As account and Social Security numbers are pretty easy to access, there is a risk that someone could download your account information and they might even be able to trade in your account. I don't think existing procedures provide adequate protection for your privacy or your money.

You may be able to block on-line access by calling your broker. You can also reduce the risk of unauthorized access by creating an on-line account yourself. Once the account exists, no one can access your information unless they also know your password. But be sure that you do not store your password in a cookie on your home computer! If you lack computer access, give me a call and I'll create the account for you.

Brokerage firms will be implementing "electronic signatures" as allowed by recent federal (Electronic Signatures in Global and National Commerce Act, S 761, June 2000) and state legislation (CA Civil Code §1633 et seq.) The mouse click whereby you agree to buy something on-line is a form of electronic signature but it is not a secure implementation of this new technology. "Digital signatures" are unique, encrypted codes authenticated by a third party and they will make our financial lives easier but I am wary about less secure forms of electronic signatures. Ask your brokerage firm about their plans.

To learn more about digital signatures, see American Bar Association guidelines at <http://www.abanet.org/scitech/ec/isc/dsg-tutorial.html>. You can access California statutes and legislation on-line at <http://www.leginfo.ca.gov/> and federal legislation at <http://thomas.loc.gov>.

Separate Share Rule. Trusts and estates often distribute taxable income to the beneficiaries rather than pay tax at the trust level. When beneficiaries receive different distributions, taxable income could be allocated among beneficiaries inequitably. The IRS promulgated Reg. §1.663(c)-2(c) last December to redress this possibility and trustees are now required to perform separate income tax calculations for each beneficiary.

This most often comes into play at death since the regulation requires the trustee to track the by-pass, marital and survivor's shares separately.

Allocating each receipt and disbursement according to the statutory procedure (CA Probate Code §16341) is a formidable task, especially since the software firms have yet to implement separate share accounting. Might approximate methods meet the reasonable, equitable and impartiality standards laid out in the regulation and California statutes?

I repeated an example that I had worked approximately in my June seminar "[Income Taxation of Trusts](#)." My conclusion is that approximate methods can be adequate and might even produce a more equitable result than the statutory rule. A discussion will be posted at <http://www.lingane.com/tax/sepsshr.pdf>.

Futures Trading. The futures market allows one to buy or sell something at a predetermined price on a future date. The margin requirement is usually three to six percent of the value of the contract.

Selling something that you do not own is risky since you will lose your shirt if you have guessed wrong about future price trends, but selling something you own is a prudent hedging strategy. A farmer can use the futures market to protect against a price decline at harvest time, for example.

Futures contracts can be profitable. For example, the Energy Department announced yesterday that eleven companies will borrow thirty million barrels of crude oil from the Strategic Petroleum Reserve and repay 31.5 million barrels in a year's time. Yesterday's price was \$31.43 a barrel and the price was lower, \$27.90 a barrel, for delivery in December 2001. By this transaction, the oil companies locked in a gross profit of \$64 million less transportation costs on an investment (margin requirement) of perhaps \$50 million.. They will also earn a year's interest on the \$942 million value of the initial contract.

I wonder why DOE chose to benefit the oil companies rather than taxpayers.

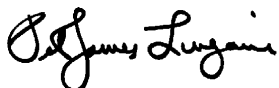
Tax Counseling for the Elderly. If you are comfortable with numbers and enjoy helping people, consider volunteering four hours a week during the February through April tax season. Some sites are frequented by seniors and others by moderate and low income taxpayers. While the dollars are often small, the tax issues can be complex. I have encountered interesting situations every season.

The IRS, FTB and AARP co-sponsor a training program in January and there is a qualifying examination. Tax professionals are excused from the exam but I have always found it to be a useful review. For more information, call me or AARP at (888) 227-7669. You don't have to be a member of AARP.

Confidentiality. AB 1016 extends the federal tax advice privilege to matters pending before the California Employment Development Department, the State Board of Equalization, and the Franchise Tax Board. Confidentiality does not apply to tax returns nor in criminal proceedings.

Please call if you have with questions on investment and estate planning issues and when you need help with individual, trust and estate tax returns.

Sincerely,



Peter James Lingane