

Managing A Concentrated Stock Position Wisely

The bear market was full of reminders of the perils of holding concentrated stock positions. In the financial sector alone, many former titans saw their share prices fall precipitously (and a few disappeared altogether). Though concentrated positions sometimes also provide extraordinary gains, a broad mix of investments holds a lower probability of loss. That doesn't mean you should immediately sell a concentrated stock position and replace it with a diversified portfolio—there are tax costs and other factors to weigh—but it does argue for managing them wisely.

Even if you discount the likelihood that a particular holding might lose most of its value, stocks' volatility could limit your investment gains. "The Hidden Cost of Holding a Concentrated Position," a recent study by investment firm Robert W. Baird & Co., compares a hypothetical stock-and-bond portfolio to the 272 stocks that were in the Standard & Poor's 500 stock index from March 31, 1999 through March 31, 2009. The hypothetical portfolio, with 60% of assets in a broad mix of stocks and 40% in taxable bonds, outperformed most of the individual stocks, whose average volatility was four times that of the diversified holdings. (Volatility, often measured in terms of standard deviation, considers changes in the market price of an investment; the more sharply the price tends to rise and fall, the greater the stock's volatility.) And while 160 of the stocks failed to keep up with inflation—and 104 lost 20% or

more—the hypothetical diversified portfolio produced a 45% gain for the decade, according to the Baird study.

One reason the diversified portfolio did so much better has to do with volatility's effect on compounded investment returns. The Baird study considers two hypothetical holdings that produced the same average annual returns during a two-year period but had very different levels of volatility. The first investment gained 50% the first year but lost 30% in year two, for an average gain of 10% and a volatility of 40%. The second investment gained 15% and 5%, respectively—also an average 10% gain but with volatility of just 5%. That makes a big difference in the performance of a \$1 million investment in each holding. The first would jump in value to \$1.5 million after one year before dropping back to \$1.05 million after the second year, for compounded annual growth of 2.5%. The second investment, in contrast, would have been worth only \$1.15 million after one year but \$1,207,500 after two—a compounded growth rate of 9.9%.

So if diversification tends to provide reduced volatility, and that in turn may translate into better results, why would anyone hang on to a concentrated stock position? There may be many reasons, including legal restrictions on selling shares in an employer. But tax costs may be the biggest stumbling block. If you sell shares that have appreciated significantly

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Slow, If Not Yet Steady Improvement

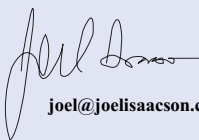
President Obama and Congress addressed the most pressing tax issues during the final legislative session of 2010, including extending the Bush tax cuts, patching AMT again, and increasing the estate and gift lifetime exemptions to \$5 million per person. The extension is only through 2012, however, so these issues will resurface again in time for the 2012 election.

The S&P 500 surged over 10% in the 4th quarter and ended up 15.1% for 2010. Small- and mid-cap stocks did even better, as did emerging markets, but developed international markets underperformed.

On the fixed income side, a larger than normal supply of muni bonds, uptick in interest rates, and several headline stories about state finances helped fuel a 4th quarter sell-off. This sell-off did not prevent most segments of the muni and taxable bond markets from finishing 2010 with solid overall performance.

Increases in exports and consumer spending helped U.S. GDP grow at 3.2% in the 4th quarter, up from 2.6% in the 3rd quarter.

Although current levels of federal and state debt and spending concern us, as do recent events in Egypt, we continue into 2011 cautiously optimistic about the economic recovery. Please contact us should you wish to discuss any of these issues and how they relate to your personal circumstances.


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Retiree Relocation: Tax-Friendly States

Are you thinking about pulling up stakes when you retire? You may want to move to a state with warm temperatures and lots of sunshine, but there's also another kind of climate to consider—the tax climate. State taxes as well as federal levies can take a big bite out of retirement income, and some states devour decidedly more than others do. Here are several factors to take into account.

State income taxes. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—have no state income tax, and New Hampshire and Tennessee tax only investment dividend income that exceeds specified limits. However, many other states and the District of Columbia provide tax breaks for retirees, so you shouldn't automatically assume a no-tax state will be the best choice.

Retirement income. Most states that normally tax income provide partial exemptions for pensions. Even better, 10 states fully exempt income received from federal, state, or military pensions. And in Pennsylvania and Mississippi, all retirement income, including distributions from 401(k)s and IRAs, is state tax-free. Some other states

impose high income tax rates on retirement income, however, with California leading the way at 9.55% on income of less than \$1 million.

Social Security benefits. Up to 85% of the Social Security benefits you receive may be subject to federal income tax. However, the seven no-tax states, 27 others, and Washington, D.C. don't tax Social Security, though other special rules may apply. For instance, in Colorado, New Mexico, and Utah, you must add back a portion of Social Security benefits not taxed on a federal level when determining your eligibility for certain state income tax breaks.

Sales tax. These levies are often overlooked when retirees contemplate a move. On the plus side, five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—currently have no sales tax, and other states may exempt food,

medicine, and other necessities. But California has an 8.25% rate, and many cities and counties pile on additional sales tax charges. In Chicago and Los Angeles, you'll pay a combined rate of 9.75%—the nation's highest. And things could get worse. In 2009, 649 U.S. cities imposed new sales taxes or increased existing rates, while only 192 reduced sales tax rates (Source: Vertex Inc.).

Property taxes.

The property tax burden varies widely throughout the country and even within states. The five states with the lowest median property taxes are Louisiana, Alabama, West Virginia, Mississippi, and Arkansas, while New Jersey, New Hampshire, Connecticut, New York, and Rhode Island have the highest.

Of course, tax rates aren't likely to be your only reason for choosing a particular retirement location. But it can't hurt to factor in these very real costs when planning your move. ●



Default Investment Options For 401(k)s

Employers are facing greater scrutiny over investment choices offered to 401(k) plan participants. Under the Pension Protection Act of 2006 and recent regulations, protection is afforded for providing “qualified default investment alternatives” (QDIAs).

Typically, problems may occur if the employer uses a qualified automatic contribution arrangement (QACA) to encourage greater plan participation. This feature generally treats employees as participants unless they “opt out” of the plan. The default investment options are triggered if participants don't take any action.

The regulations say that plan fiduciaries are relieved from liability for losses resulting from default investments if six requirements are met.

1. Investments are made in a QDIA managed by an appropriate financial professional, trustee or fiduciary. The QDIA can't invest in the employer's securities and must be limited to these investment strategies.

- A “target maturity fund” geared to the age, normal retirement date, or life expectancy of the participant
- A balanced fund using an asset mix based on the ages of the participants
- Investment management services in

which an investment manager allocates assets based on varying degrees of long-term appreciation and capital preservation

2. The participant must have the ability to direct investment of assets, but failed to do so.

3. Generally, participants must be notified of the default rules at least 30 days before initial eligibility.

Exception: For plans with automatic enrollment allowing contribution withdrawals without a tax penalty, notice may be provided as late as the date of plan eligibility.

4. Any materials relating to the QDIA must be provided to the

Five Second-Marriage Financial Snags

“Blended” families, once unusual, have become increasingly common.

They’re typically the result of a divorce, after which one or both ex-spouses remarries, frequently to a husband or wife who also has children from a previous marriage. There are about one million divorces in the United States each year, and it’s estimated that almost half of all families today are of the blended variety.

Unfortunately, not every “Brady Bunch” lives in bliss and harmony, and discord is particularly likely after your death. Consider these five areas in which your blended family might face avoidable financial snags.

1. Beneficiary designations. Writing a former spouse out of your will may be at the top of your post-divorce to-do list, but it’s also crucial to remember all of the other places you designated your once beloved as primary beneficiary. That may include life insurance policies, retirement accounts, trusts, and annuities. And you likely shouldn’t just write in the name of your new spouse. Deciding how and whether your new spouse and your own children share in your estate may involve complicated planning and could mean establishing one or more trusts—and you’ll need to coordinate all beneficiary designations with the provisions of your revised estate plan.

2. Tax-free gifts. A relatively simple

way to look after the needs of children from a first marriage is through a series of tax-free gifts. You may currently give \$13,000 annual gifts to as many recipients as you choose without incurring gift tax liability. So, if you’re relatively young, you might use this provision to begin transferring assets to your children (and possibly your grandchildren), presuming you can afford to gift that much. Over a decade or two, you could help your offspring build substantial savings. But your early death would undercut this strategy, and it’s important to consider who’s getting the money. For example, making yearly gifts to both a child and the child’s spouse would enable you to give more but might put money in the hands of a son- or daughter-in-law who later divorces your child.

3. Estate executors. In simple estate planning situations, it often makes sense to choose a spouse or other trusted family member as estate executor. Particularly if that person stands to inherit a substantial part of your assets, he or she is likely to be conscientious about following the provisions of wills and trusts and making sure your wishes are carried out. But that approach isn’t likely to work in a blended family. A new spouse or one of your children will have different interests and may not be able to agree with other family members. Unless you want a judge to sort out the mess, it’s generally better

to appoint an independent third party. Moreover, a professional acting as executor may provide other valuable benefits to the estate.

4. Power of attorney. A power of attorney is a valuable estate planning tool, but your intentions may be thwarted if the wrong person gets this responsibility or it isn’t handled properly. This legal document establishes the right for another person to act on your behalf, and that person could use it to transfer assets to a trust, for example, or to make annual tax-free gifts—basically, to take over any tasks you may be unwilling or unable to handle yourself. This authority can be either broad or specific—for example, it could be limited to selling securities or other possessions. Here, too, it often makes sense to give this power to a family member, but in a blended family that could lead to conflicts. Appointing someone from outside the family may be preferable, and it generally makes sense to have a durable rather than a general power of attorney.

5. Trusts. Various trusts can help sort out assets and interests for blended families. But even some trusts frequently used in such situations could cause problems. For example, a “qualified terminable interest property” (Q-TIP) trust can divide your assets between a surviving second spouse and the children from your first marriage. Typically, the spouse gets to use the trust income, while the children, as trust beneficiaries, receive the trust assets after the spouse dies. But this arrangement may spark disputes between the spouse and the children regarding management of trust assets, with the spouse possibly emphasizing current income while the children preferring asset appreciation. One solution is to give an independent trustee the ability to make adjustments so that everyone is treated fairly.

The bottom line is that the special dynamics of blended families make careful estate planning imperative. We can work with you and your attorney to create planning strategies and vehicles that serve the needs of you and your family. ●

plan participant. This includes prospectuses, account statements, proxy voting materials, and the like.

5. Participants must be able to transfer QDIA assets as often as other investments. In any event, they must be afforded this opportunity at least once within every three months. During the first 90 days of the initial default investment, no additional restrictions, fees, or expenses may be imposed on transfers out of the QDIA or

permissible withdrawals under the automatic enrollment rules.

6. The plan must provide a “broad range” of investment alternatives to participants and beneficiaries. This mirrors existing rules for 401(k) plans which generally require using at least three funds with varying risk and return profiles.

These regulations can give greater comfort to employers and fiduciaries as well as providing guidance for plan design. ●



It's NOT The Economy, Stupid!

In 1992, then-candidate Bill Clinton used the slogan “It’s the economy, stupid” to help him stay on message and pound President George H.W. Bush for his failure to pull the country out of a recession. The point was that jobs and other economic issues were what mattered most to voters. Yet while that may still be true as far as elections go, it oversimplifies things when it comes to investments. Your results ultimately have more to do with the choices you make in responding to economic conditions, rather than the actual state of the economy itself.

This is an important distinction that underscores the limits of a pure “buy and hold” strategy that just sticks with investments to wait for them to match their average past performance. While stocks do tend to track the general economy over very long periods of time—and stocks, like the economy, have always ultimately prospered—few investors can afford to wait several decades for beaten down investments to bounce back. Instead, it makes sense to take steps to mitigate the risk of sharp losses.

The events of the past few years

have forcibly illustrated the fact that equities can be extremely volatile in the short term. And even if you’re still 20 or 30 years from retirement, market ups and downs have a real impact on your returns. It’s only at the 40-year mark that returns tend to fall in line dependably with economic progress, according to a recent study by economist Richard W. Kopcke and researcher Dan Muldoon at the Center for Retirement Research at Boston College.

Their study—“Why Are Stocks So Risky?”—shows that investor behavior has a far stronger influence over returns than do the gyrations of the economy, especially over periods of 20 years or less. The authors define investor behavior as “the way shareholders react to their uncertainty about economic conditions, form opinions about the future, and manage their portfolios.”

The good news is that of the two factors—economic conditions and

investor behavior—that influence investment returns, the one that exerts the greater influence is the one you control. What really matters are the decisions you make in setting up and operating your investment portfolio.

Those choices include everything from defining your risk tolerance and setting life goals to diversifying your portfolio and reallocating assets in response to shifting short- and long-term trends. Maintaining broad diversification spreads your risk across and within multiple asset classes, and making regular, strategic reallocations helps you stay diversified even as conditions change.

Now, as the economy embarks on what could be a long, uncertain recovery, we can help you make sure that your portfolio is positioned to reflect who you are and what you want to accomplish.

Diversification does not guarantee investment returns and does not eliminate the risk of loss



Managing Stock Wisely

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since you bought them, you could find yourself paying today’s 15% tax on long-term capital gains on almost the entire proceeds (unless you have large capital losses from this year or a prior year to offset your gains)—and that knocks a large hole in a new, diversified portfolio.

There are several alternatives to selling all at once. You might offset some risks of further concentrating your position by avoiding that holding’s company and industry in the rest of your portfolio. You could divest your shares gradually in order to stretch out your tax liability. Very wealthy investors may be able to put a portion of concentrated holdings into an exchange fund, which avoids immediate taxes and gives investors shares in a

diversified portfolio. Using some of the stock position to fund charitable goals could provide tax advantages

and income, and company insiders might use a preprogrammed selling program known as a 10b5-1 to unload restricted shares.

All of those possibilities involve complex planning issues and need to be considered in view of your overall financial goals. For example, the current capital gains tax rate is the lowest it has been in many decades and may rise soon, and that could make it advantageous to

Five Ways To Manage A Concentrated Stock Position

1. Avoid similar holdings in the rest of your portfolio
2. Divest your shares gradually to stretch tax liability
3. Fund charitable goals with part of your holding
4. Put a portion of the stock into an exchange fund
5. Use a 10b5-1 preprogrammed selling program

incur those taxes now, not later. We can work with you to assess the vulnerability of a concentrated stock position and help you manage it wisely. ●

¹The hypothetical stock portfolio in the Baird study had 12% of assets in large-cap growth, 14% in large-cap value, 8.5% and 3.5% in mid-cap and small-cap shares, respectively, 14% in international holdings, and 8% in a mix of “satellite” investments (emerging markets, high-yield bonds, commodities, and real estate).