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Trust UPDATE

October 2019

The top 10 questions we're asked about trusts

Trusts aren't just for tycoons anymore. From architects to zoologists, from account executives to zinnia growers, people with money to invest are using trusts to create greater financial security for themselves and their families.

A *trust* is a tried-and-true method of arranging for the continuing care and management of property. Typically a trust is created when someone transfers money or property to a trustee, either a person or a trust institution such as ours. The trustee holds title to the trust assets and manages the trust fund solely for the benefit of one or more *beneficiaries*.

For example, Mrs. Smith might set up a living trust when she retires, designating herself as the life beneficiary. At her death, when the trust ends, the trustee will distribute the remaining assets to Mrs. Smith's daughter, the designated *remainder beneficiary*.

Because of the growing interest in the use of trusts, we receive more and more questions on the subject. Here we address the ten that we've heard most often.

10. What are revocable trusts? Are they the same as living trusts?

Living trusts may be either revocable or irrevocable. *Revocable* means that the creator of the trust remains free to cancel the trust agreement and reclaim the trust assets. In other words, he or she may revoke the trust at any time. *Irrevocable* means the creator of the trust cannot cancel the trust or change its terms. Once an irrevocable trust is created, it must run its course.

Living trust is simply the label applied to any trust that a person created during his or her lifetime. A *testamentary trust*, by contrast, is created by means of trust provisions in a person's will. Such a trust does not go into effect until after the person's will is probated.

9. When I set up a living trust, do I lose control of my assets?

No, not unless you make your trust irrevocable. When your living trust is revocable, you're in the driver's seat. You can change successor beneficiaries, add more assets, withdraw assets, and make any other adjustments that you wish to make from time to time.

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From architects to zoologists, from account executives to zinnia growers, people with money to invest are using trusts to create greater financial security for themselves and their families.

8. How do I set up a revocable trust?

It's simple enough. You give us written instructions in a trust agreement, prepared by your attorney, and you deliver to us the money, securities, or other property that you wish us to hold in trust. That's about all there is to it. As noted above, you remain free to modify your instructions or cancel the trust anytime.

7. Can I be my own trustee?

Yes, you can be the trustee of your trust, or you can have a trusted family member be the trustee. But that's not a course we would recommend. Some very important reasons to let us be trustee of your trust are:

- To gain access to professional management of your assets.
- To have someone available to stand in your financial shoes should illness or incapacity strike.
- To provide financial support for your loved ones during your lifetime and beyond.
- To put all the chores of trust administration into experienced hands.

A partial list of what a trust can do

No single trust can do everything, but for almost any imaginable need, there is a matched trust solution. How many of these objectives do you have?

- ☐ Continuous financial management in the event of incapacity
- ☐ Professional investment management
- ☐ Provide financial support for a special needs person
- ☐ Financial privacy
- ☐ Probate avoidance
- ☐ Lifetime financial protection for a surviving spouse
- ☐ Asset management for inheritances
- ☐ Creditor protection for heirs
- ☐ Inheritance for children from an earlier marriage
- ☐ Future legacy for charity
- ☐ Current income for charity, keeping assets in the family at lower cost
- ☐ Protection from current and future estate taxes

6. How much income does a trust generate?

Using a trust doesn't necessarily change the amount of income that a portfolio generates. In a traditional trust, "income" means collected interest and dividend payments. With that approach, as interest rates and dividend yields rise and fall, income changes with them. Changes in asset values—growth in stock prices, for example—accrue to the remainder beneficiaries.

Some trusts today take alternative approaches, defining income as a percentage of trust assets, or as a fixed dollar amount every year, or as a dollar amount adjusted for inflation—there are many alternatives to consider. However, if a fixed percentage is used to determine distributions, and the income falls short, the trustee will have to invade the principal to make up the difference.

5. How old should you be to set up a trust?

There is no "best age" for setting up a trust. Many young entrepreneurs have used trusts for their wealth management once they achieve early success. As a practical matter, a great many people first give serious consideration to establishing a trust as they approach retirement, or when they do their estate planning.

4. Suppose I'm selling a business or some property. Must I set up a trust in order to have you invest the proceeds for me?

No, you can easily take advantage of our asset management experience by setting up a less formal investment account. Many people structure their investment program as a revocable trust for one or both of two reasons:

1. The terms of a trust may authorize us to provide full personal financial management services if a need arises—during a period of prolonged illness or incapacity, for example.

2. A revocable trust facilitates estate planning, offering advantages popularly referred to under the general heading of "avoiding probate."

3. What's the primary purpose of avoiding probate with a living trust? Cutting costs?

In a few states where probate costs remain unusually high, living trusts may indeed result in significant cost reductions following the death of the creator of the trust. More usually, however, people seek to avoid probate in order to lessen the delays associated with conventional estate settlement. A living trust can provide virtually uninterrupted income and support for a spouse, a child, or other designated beneficiaries.

In addition, the terms of a living trust usually remain private following the death of the creator of the trust. The terms of a probated will, by contrast, go on public record. By preserving estate privacy, living trusts may help to shield the families of financially successful men and women from unwelcome publicity.

2. Does a living trust eliminate the need for a will?

As a practical matter, no. One still needs a will to dispose of assets not placed in the trust, and to tie up loose ends. Keep in mind that a modest probate estate can have advantages. Once probate proceedings have given any alleged creditors their day in court, later claims against the estate are generally barred.

1. Is trust service expensive?

Not when you select us as your trustee. People are usually surprised to discover that their annual fees compare favorably with the annual fees of other investment managers, notably hedge funds. Our trust service offers a person-to-person contact and responsiveness that you just can't expect from the 800-number. As one of our trust customers put it recently, "Do you know, I really feel like I'm flying first class for the price of coach."

If you have questions of your own about trusts or our investment services, make an appointment to meet with one of our trust professionals at your earliest convenience. We will be pleased to tell you more. ☐

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Diversification nuggets

Diversifying an investment portfolio helps to smooth returns over time, lowering risk and volatility. In "Digging Deeper into Diversification" (*AAII Journal*, September 2019, p. 19), Paul Merriman offers some useful food for thought for investors.

The odds on picking stock market winners are not great

A study published by the *Journal of Financial Economics* in 2018 compared the returns of all common stocks available for investment since 1926 to the returns from Treasury bills. Everyone knows that stocks have greatly outperformed T-bills. But the study found that this excess return was attributable to only 4% of the individual stocks. Only one stock in 25 was a long-term winner. The remaining 96% of stocks merely matched the T-bill return, at much higher risk.

Equal weight versus market cap

The S&P 500 index is weighted by market capitalization. That means that giant companies have more influence on the movement of the index than the smaller companies. The 20 largest companies by capitalization account for about 30% of the index, while the remaining 480 make up 70%. That means a 5% uptick in, for example, Microsoft, will have a noticeable effect on the index, while a 5% gain for TripAdvisor may not mean much at all.

An alternative to weighting by market cap is to give every company equal weight, "making the kings into commoners." An S&P 500 Equal Weight Index was created in 2003, in which the large and small companies have equal influence on the movement of the index. Paul Merriman reports that his research suggests equal weighting may add 0.25% to 1.0% to total return. However, when the equal weighting formula is applied to other indices, such as technology stocks, returns are reduced. Accordingly, Merriman suggests considering equal weighting as an added diversification layer, not a substitute for traditional capitalization weighting.

Bonds

Merriman reports that bonds are low risk in the short term, but not so low risk long term. In a majority of the last 91 years, T-bills, government bonds, and corporate bonds have lost money after inflation and taxes are taken into account.

Categories

Morningstar rates stocks and stock funds as growth, value, or blend, based upon a variety of metrics. For example, growth stocks may have low or no dividends, while value stocks tend to be out of favor and so have higher dividends relative to their prices.

Merriman has been tracking a portfolio made up of just four U.S. asset classes: the S&P 500, large-cap value stocks, small-cap blend, and small-cap value. Each category has produced double-digit returns over 40-year periods. What's more, the S&P 500 benchmark was the weakest of the categories.

The table below shows the result of investing $100 in each category for 40 years. The worst performance of each is compared to the best result for the S&P 500. Rates of return seem less antiseptic when they are translated into dollars.

Worst 40-year periods, 1970-2018

Category	Return	Growth of $100
S&P 500 (BEST)	12.2%	$9,993
U.S. large-cap value	13.1%	$13,756
U.S. small-cap blend	12.5%	$11,120
U.S. small-cap value	15.4%	$30,777

Source: Merriman, "Digging Deeper Into Diversification," *AAII Journal*, Sept. 2019

What about your portfolio?

Are you confident that your investment plans will weather any economic storms that might be coming our way? We'd be pleased to share our investment observations with you. Disciplined investment management is a core part of our business. ☐

Are tax deductions necessary?

Tax reform in 2017 eliminated the personal exemption and capped the deduction for state and local taxes at $10,000. These changes were offset by a dramatic increase in the standard deduction. With so many fewer people itemizing their deductions, it was argued at the time that the follow-on effects of the changes could be that charitable giving would contract, and housing prices would fall.

The tax law worked as intended, according to the latest IRS reports. The number of taxpayers claiming the standard deduction rose by 28.8% for the 2018 tax year, with a dollar increase of 153.4%. The number of returns claiming deductions for mortgage interest, charitable contributions, and state and local taxes fell by more than 60%. The dollar value of those deductions dropped 35.8% for charitable contributions, 46.5% for mortgage interest, and 48.0% for state and local taxes.

And yet. Writing in the Axios online newsletter, Felix Salmon observes that total charitable giving rose in 2018. It did not fall as was feared, despite the fact that the stock market plunged toward year-end when many major gifts occur. Home prices in the country as a whole have continued to rise. Mr. Salmon's bottom line: "Tax deductions are much easier to create than they are to abolish; they're also hugely expensive. The evidence strongly implies that almost all of them are a waste of money."

Still, it may be too soon to pronounce judgment on the full effects of tax reform, whose benefits may not be uniformly distributed. The wealthy may yet decide to move from the highest-tax states. One analysis showed that Connecticut taxpayers owed an additional $2.8 billion on their federal tax returns for 2018. A couple with taxable income of $500,000 might owe $50,000 in state and local taxes in New York, $46,000 in California, or $32,000 in New Jersey. That is quite an incentive for a change of residence.

Cash those checks!

An employee was due a $900 distribution from his employer's qualified plan. The plan withheld income taxes and sent the employee a check for the balance. The distribution must be included in taxable income for the year in which the check was cut. For unknown reasons, the employee never cashed that check, nor did he attempt to roll the distribution into an IRA.

Failure to cash the check during the tax year that the distribution occurs does not avoid any income tax, the IRS holds in *Revenue Ruling 2019-19*. The tax result would be the same if the employee kept the check, sent it back, destroyed it, or cashed it in a subsequent year. Nor does the employee's action change the employer's obligation of withholding or reporting responsibilities. ☐

Let us help you choose the best options for preserving your wealth.

Our Trust Division is staffed with friendly and knowledgable advisors to help you make the best decisions for managing your assets and transferring them accordingly when the time comes.

For more information, call (870) 793–4441.