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# Future Returns May Require More Active Management

also in this edition:

12 Estate Planning Must-Dos

Charitable Ideas for What to Do With Your Money

Don't Be Scared to Re-Allocate Your Portfolio





# ***DON'T BE SCARED TO RE-ALLOCATE YOUR PORTFOLIO***

The performance of the U.S. equity markets has been strong in 2021. In fact, the major U.S. equity markets have reached new highs, spurred on by a continued economic recovery, improved unemployment numbers and an accommodative Federal Reserve.

As we enter the final quarter of the year, it might be time to take a hard look at your portfolio allocation to make sure you are properly positioned to minimize risk and protect it from potential market troubles.

Most investors recall the Covid-19 driven market declines in early 2020, but it doesn't take a pandemic for market volatility to increase. Do you remember Thanksgiving week in 2018? The S&P 500 went negative, led by the group of tech stocks which officially entered bear market territory after dropping more than 20% from their 52-week highs?

Do you remember that shortly after Thanksgiving 2018, the S&P 500 kept posting red numbers on its way to a -9.2% return for the month of December 2018? Hopefully, you will remember this: the best way to protect your portfolio from unexpected market volatility is through smart asset allocation, aided by diversification and rebalancing.

## **Diversification and Asset Allocation**

Diversification means the mathematical process of reducing risk through the use of many different types of assets. Diversification combines mutual funds, ETFs, closed-end funds, stocks, bonds and other securities that are not correlated. In other words, one asset class typically zigs while the other zags.

Asset allocation is when risk versus reward is balanced, according to the risk capacity, risk tolerance, time frame and goals of the investor. Many people believe that when they have more investments, it means they are more diversified. Wrong.

## **Asset Allocation Basics**

When allocating assets, you need to do two things:

1. Find asset classes that are distinct and don't overlap. You are not as diversified as you think if they do.
2. Examine how they interact with each other. Different classes tend to do different things at different times.

So, it is not necessarily how many positions you have in your portfolio, but what makes up the contents of the positions to begin with. You have the entire global economy to locate them. You could cut the portfolio into very tiny pieces. However, those likely would be similar to other tiny pieces nearby.



## The Big Picture

Work from the broader big picture on down, using specific investments for defined asset classes. And pay attention to rebalancing.

Rebalancing is a financial planning tool designed to get your portfolio back to your original allocation target. Why? Because with time your allocation drifts, and you take on a different risk profile as a result of this drift.

## A Sample Portfolio

You might choose to invest in individual stocks, or perhaps you prefer to use index funds, or actively managed mutual funds – or maybe a combination of all these. The specific investment choices have their own individual positives and negatives, and the choice you select may depend upon your personal preference, the size of your portfolio, etc. The important point is to choose wisely.

Let's also assume you have a global asset allocation with exposure to many different asset classes. What happens when, say, your Energy fund declines and now makes up a smaller piece of your portfolio than you want in your asset allocation? Or if the Information Technology portion of your portfolio is too big? Your next step is to rebalance.

You sell off a portion of your portfolio that has expanded too much and buy into the asset class that has declined. In other words, you sell some of the Information Technology index fund and buy more of the Energy index fund (this is just for illustrative purposes and not a recommendation to buy or sell one asset class for another by the way).

Remember the old saying, "Buy low, sell high?" Well, rebalancing means you are doing just that, except you sell high first, then buy low. You sell some of what has gone up to buy more of what has gone down, thus restoring your desired asset allocation pie and remaining consistent with your risk profile.

But beware: selling "winners" and buying "losers" goes against the grain emotionally, of course. So, you make this a regimen in order to eliminate some of the emotional challenges.

## Portfolio Allocation and Financial Planning

You might be able to construct a solid portfolio allocation on your own. It will take some pretty dedicated research into the various asset classes, and then you'll have to make some assumptions about your future asset growth and income needs. But having the assistance of a good financial planner can make this process a lot easier.

- Talk to your financial advisor about different types of assets available. (allocation).
- Ask questions about the ingredients your financial advisor uses to make portfolio allocation (diversification).
- Recognize that sometimes you need to reduce the amount of the best performers and add more to the under performers. (rebalancing).

But most importantly, know that your financial advisor will create an asset allocation specifically tailored to your needs. (financial planning).





# Future Returns May Require More Active Management

Over the last forty years, investors have experienced a truly remarkable era of nearly uninterrupted growth in U.S. financial markets. Most investors are familiar with the long-term picture of total returns in the equity market. However, income oriented investors in long-term bonds, have similarly seen an amazing performance of their portfolio since 1981 that has resulted in a more than fivefold increase in real value. This growth was fueled by a more or less unchecked downward trend in short-term interest rates and long-term yields from the high levels of the early 1980s, with the 10-Year Treasury yield falling to just 0.4% in 2020.

Investors in bonds who reinvested interest payments over the past forty years have done exceptionally well, yet with yields having fallen to the lowest levels in history, the investment landscape is now fundamentally different. Instead of simply admiring the past gains, income focused investors should now be asking themselves what potential risks are embedded in these records of past portfolio growth.

In light of the decline in yields to near zero in 2020, investors should ask themselves whether bonds alone are able to fulfill their traditional role of counterbalancing risk assets going forward.



When investors receive ultra-low yields from bond allocations, total returns from a bond only income allocation are guaranteed to be low, and can potentially turn negative if yields rise — exacerbating portfolio volatility, instead of dampening it.

Similar to the long-term performance in bonds over the last forty years, an investment in equities has seen a strong positive return also. An investment in the S&P 500 received an earnings yield of 13% in 1981, and a downward trend in earnings yield since then coincided with a forty-year expansion in valuations.

In contrast to the early 1980s, the S&P 500 today offers an extremely low earnings yield. With such ultra-low, real world yields in stocks and bonds, the risk/reward environment today is the opposite of the early 1980s, and this poses a particularly acute dilemma for conservative investors focused primarily on U.S. based investment choices. On the one hand, the benign conditions of the last forty years produced beautiful buy-and-hold returns in a standard portfolio allocation of stocks and bonds, but on the other hand those conditions have resulted in a severely over valued market environment.

The effective yield of a conservatively allocated portfolio of stocks and bonds today is near 2%, the lowest effective yield in data going back to the 19th century, and it represents the nominal total return investors in U.S. stocks and bonds can expect in the years ahead if yields remain low.

If yields do not remain low and instead embarked upon a consistent pattern higher, the result could compress equity valuations and drive bond prices lower. In this environment, total returns from passively holding a traditional portfolio of stocks and bonds could possibly be lower than 2%, or even negative.

The prospect of low or negative returns from passively holding stocks and bonds represents a dilemma to conservative investors averse to making regular changes to their holdings: the vast growth in recent decades resulted in a perfect scenario — solid returns without the need to actively trade - but there are now significant risks which were not present before.

Maintaining overall portfolio integrity when risk asset yields are low is critically important, yet investors may need to incorporate more active portfolio management strategies in the future to achieve an acceptable total return from equities and enjoy the portfolio diversification that bonds provided in decades past.



# 12 ESTATE PLANNING MUST-DOS

Many of you already have estate documents, probably executed many years ago. Preferably you should have an estate attorney look over your documents every 10 years or so. Here are a dozen points to review.

1. Do you have a will and powers of attorney for health care and property? These are part of every complete estate plan. With health-care power, you choose an agent to act on your behalf if you become unable to make your own decisions. With durable power for property, you select an agent to act if you are incapacitated and can't sign a tax return, make investment decisions, make gifts or handle other financial matters.

Make sure your health-care power addresses the Health Insurance Portability and Accountability Act. This governs what medical information doctors can release to someone other than the patient.

2. Do you need to change any beneficiaries, executors, trustees, guardians or others named in your documents? Are all still living? Can someone you recently found fill a role better?
3. Any updates needed to addendums to your will that specify who gets what of your personal property? Often I read wills that mention addendums for personal property and the addendums don't even exist.
4. Did you move to a different state since the execution of your estate documents? If so, seek out a local estate attorney to check any legal differences for planning between your old and new states.
5. Do you still need your trust documents or can you decant, which allows you to change some provisions? Consider this technique of emptying the contents of an irrevocable trust into another newly created trust if you are unhappy with your irrevocable trust. Not all states allow decanting.

You may also want to discuss possibly moving assets out of a living trust (where a trustee holds them, a technique sometimes used to avoid probate) and holding them in the name of an individual.

This discussion will weigh the income tax benefits of a step-up in cost basis, the original cost of an asset, versus other reasons to keep the trust. ("Step up" means that the cost basis of an asset resets to the fair market value of the security as the date of the holder's death - potentially a much higher value than when they bought the security.) The higher the cost basis, the less capital gains tax your heirs pay when they sell the asset.

You may also want to see whether you need an irrevocable life insurance trust, a device once used to move assets, typically life insurance, out of a taxable estate. Currently thresholds are higher - individuals can leave \$11.58 million and married couples \$23.16 million tax-free - you may not need to move assets. (Be aware though these thresholds could decline in the future)

6. Have your children passed the ages specified in a children's trust (in which you designate money for such specific purposes as education, home down payments or weddings once the kids reach stipulated ages)? If your estate documents call for a trust to give children access to money at certain ages after you die, you may be able to delete that language if the kids are older than the specified ages.
7. What happens if one of your kids gets divorced? A trust can help you protect assets for your child or grandchild.
8. Do you have heirs with special needs? Don't assume typical estate documents help such an heir. Seek out a financial advisor and attorney who specialize in this planning.
9. Check beneficiary designations on brokerage accounts, insurance policies and retirement accounts. Anybody you don't want there?
10. If you filled out a brokerage account application (or any beneficiary designation), understand the firm's policy when one beneficiary dies before the others. If you want the share of the assets to pass by blood line - to the deceased's children, for example - you may need to put in language specifying per stirpes (distribution of property when a beneficiary with children dies before the maker of the will).

Otherwise, the remaining listed beneficiaries may simply divide the assets.

- 11 Often a parent names a child on a bank account so the child can access or use the money if the parent can't act. Understand that if you name your child as a joint owner on an account, the money passes to your child no matter what your will dictates.

The child splitting the money with someone else constitutes a gift, though one probably not subject to gift tax now that gifts of less than \$5.34 million aren't taxed. Still, think carefully so you keep the family peace.

12. Do your heirs know where to find all your important information? Let someone know the password to the app where you keep all your passwords - you must remember digital assets now, too.



# Charitable Ideas for What to Do With Your Money

Giving away some of your money is a great way to support the people and organizations you love. But there are smart ways to do it, minimizing your taxes and avoiding pitfalls along the way.

Once you have provided for your own retirement and met your personal expenses, think about benefiting others – whether it's your parents, children, grandchildren, friends, neighbors, church, synagogue, mosque, school or service organization. Your money is usually happily received, and you get a warm feeling from being a benefactor.

## Learn From the Greats

Consider some of the great givers.

- John D. Rockefeller lived the last 40 years of his 97 in retirement. He gave vast sums to education, medicine and scientific research, fundamental in the elimination of hookworm and yellow fever.
- Andrew Carnegie spent the last 20 of his 83 years as a philanthropist and funded some 3,000 libraries.
- Microsoft's Bill Gates' foundation has given billions to enhancing health care and reducing poverty.

You may not have the resources of a Rockefeller, Carnegie or Gates. But here are some prudent ideas for what to do with your money:

**1. Give \$15,000 per year to family, friends and other people you love.** You may make an unlimited number of gifts, up to \$15,000 each, of cash or other property each year, completely tax-free. If you left the same gifts at your death and your assets were subject to the estate tax, the recipients would see their gifts shrink by around 50%.

**2. Open a joint account with those to whom you wish to give your money.** Retain the checkbook, debit cards and other access points to retain as much control as possible. The account can avoid probate when you die. You can also list the beneficiary's name first on the account, and this person will pay the taxes on any earnings from it.

There are disadvantages however, and these include:

- If the other joint owner has access to the money, he or she can take it all at any point.
- You share liability for bounced checks by the joint owner and the assets are subject to the creditors of any joint owner.
- The entire account is subject to estate tax at the first owner's death.

**3. Utilize charitable giving.** This type of giving may provide current tax savings and minimize or avoid estate taxes. The money you donate is an investment in your community, the nation and the world.

Of course, it's wise to be cautious when donating. Research the organizations to which you wish to donate, and be sure that your money will be used in the way that you desire.

## Charity Giving Precautions

These steps will increase the probability that your donation dollars will benefit the people and organizations you want to help.

**Trust, but verify.** Be cautious of charities that spring up overnight in connection with current events or natural disasters. They may make a compelling case for your money, but they most likely don't have the infrastructure to get your donations to the affected areas or people.

**Call the charity.** Ask if the organization is aware of a solicitation you received and has approved it. If not, the solicitation may be a scam, mounted in the charity's name.

**Verify the contribution is tax deductible.** Your contribution may not be deductible. If a tax deduction is important to you, ask for a receipt showing the amount of your contribution and stating that it is tax deductible.

**Trust your instincts.** And check their records if you have any concern about contributing. Callers may try to trick you by thanking you for a pledge you didn't make. If you don't remember making the donation or don't have a record of your pledge, resist the pressure to give.

**Ignore high-pressure sales.** Legitimate fundraisers generally don't push you to give on the spot. Be wary of charities offering to send a courier or overnight delivery service to collect your donation immediately.

**Consider the costs.** When buying merchandise or tickets for special events, or when receiving free goods in exchange for giving, remember that these items cost money and generally are paid for out of your contribution. Although this can be an effective fundraising tool, less money may be available for the charity.

**Be wary of promises of sweepstakes winnings in exchange for a contribution.** Under U.S. law, you don't have to donate to be eligible to win a sweepstakes.

**Do not send or give cash.** Cash can be lost or stolen. For security and tax record purposes, it's best to pay by credit card or check -- made payable to the charity, not the solicitor.

**Talk to your financial advisor.** Your advisor is one of your best sounding boards and safeguards as you consider your charitable contributions.

**Read that last one again.**



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