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The New Rules for Diversification

by Randy Myers

For some investors, the takeaway from the financial market meltdown of 2008 was that diversification no longer works. After watching assets of virtually every kind crash that year, many investors concluded that you really can't protect your money anymore just by spreading it among different types of investments.

Now many investment professionals, however, are drawing a different conclusion. It's not that diversification doesn't work, they argue, but that investors haven't been sufficiently aggressive in its application. Too often, they say, investors thought they were diversified if they simply added a few bonds to their stock portfolio and maybe tacked on a small allocation to an international stock fund for good measure.

That's not enough, says Michael O'Keeffe, chief investment officer for Merrill Lynch Wealth Management, a unit of Bank of America Corp. A typical investor today, he says, should start with a globally diversified portfolio of stocks and bonds plus a modest allocation to cash, and then consider adding real assets such as real estate, commodities, and Treasury Inflation-Protected Securities, or TIPS. At higher levels of wealth, non-traditional investments such as private equity funds, hedge funds and structured products should be considered as well. Overall, an investor should keep his or her risk appetite in mind, he says, and be globally minded across multiple asset classes.

"I don't think the basic asset classes should be discarded," echoes Certified Financial Planner John McAvoy of Waterstone Retirement Services in Canton, Mass. "But I don't think they are sufficient to diversify a portfolio in today's environment."

Assessing Alternatives

Many of the alternative investments O'Keeffe and others recommend were once considered too risky or expensive for most investors, or, where the accredited investor rules apply, were simply inaccessible. Others, like private equity and hedge funds, were considered too illiquid, meaning they often couldn't be sold on short notice. But new products introduced over the past few years are making alternative investments available to a wider swath of the investing public. Mutual funds have been introduced, for example, that mimic hedge fund investment strategies without charging hedge fund fees, can be easily traded and aren't limited to accredited investors.

Meanwhile, research has shown that assets that can be risky in isolation may actually dampen the amount of risk an investor takes on when used as part of a broadly diversified portfolio. That's because their returns tend not to correlate closely with returns on domestic stocks — the prime building block of most investment portfolios. In other words, when stocks go down, commodities, to cite just one example, don't always follow suit.

To be sure, that wasn't the case in the fourth quarter of 2008, when the financial crisis was at its fevered pitch. Then, investors worried that Wall Street itself might fail flocked in droves to the safety of U.S. Treasury bonds, pulling money from, and driving down the value of, virtually every other investment, including most alternative asset classes.

But that was an extraordinary event, and to extrapolate from that one quarter that diversification does not work would be akin to concluding that the forward pass does not work in football just because your favorite quarterback was intercepted three times in last year's big game.

Consider calculations performed recently by Brinton Eaton Wealth Advisors, a financial advisory firm in Madison, N.J. Based on data compiled using Morningstar Encorr, the firm compared the performance of two investment portfolios — one moderately diversified, the other more broadly diversified — using a variety of widely followed indexes.

The moderately diversified portfolio had 65 percent of its assets in large-company U.S. stocks and the remaining 35 percent in a portfolio of U.S. bonds. The second portfolio allocated just 45 percent of its assets to large U.S. stocks and 30 percent to domestic bonds. It also put 5 percent in international stocks, 15 percent in commodities and 5 percent in real estate.

In 2008, both portfolios lost money — 22.2 percent for the moderately diversified portfolio, 26.7 percent for the broadly diversified portfolio. In 2009, however, the broadly diversified portfolio won the race, earned 21.1 percent versus 19.3 percent for its more pedestrian competitor. More impressively, over the 10 years ending December 31, 2009, the broadly diversified portfolio grew by an average of 4.5 percent annually versus 2.2 percent for the other portfolio.

"The underperformance of the broadly diversified portfolio in 2008 was entirely attributable to the fourth quarter," notes Certified Financial Planner Jerry Miccolis, a senior financial advisor with Brinton Eaton Wealth Advisors and co-author of *Asset Allocation For Dummies* (Wiley, 2009). "It was outperforming for the first nine months of that year, and it outperformed in the following year. In fact, if you exclude the fourth quarter from the comparison, the broadly diversified portfolio earned 6.9 percent during the 10-year period we studied, versus 3.7 percent for the narrowly diversified portfolio. The idea that diversification is dead simply because it didn't save the day in the fourth quarter of 2008 is silly."

It's All in the Allocation

Deciding to follow through on a broad diversification strategy requires that investors, or their financial planners, answer at least two critical questions: how much should be invested in alternative asset classes, and in what form?

The optimal asset allocation mix will vary from investor to investor based on their personal circumstances, including their financial qualifications, their appetite for risk and their tolerance for illiquidity. Anil Suri, an asset allocation specialist and head of investment analytics at Merrill Lynch, says his firm will recommend allocations to alternative assets ranging anywhere from zero percent to 45 percent of the portfolio depending upon these factors.

Miccolis is making greater use of alternative assets today than he did just a couple of years ago. His firm now invests as much as 35 percent of its clients' money in alternative investments, up from 20 to 25 percent prior to 2009. "It's a pretty big number," he concedes, "but it's appropriate to protect our clients' portfolios."

What investors shouldn't do, Suri warns, is make token investments. To have any value, he says, each allocation to an alternative asset class must be sufficiently large to have a material impact on the risk and reward characteristics of the overall portfolio.

As for gaining exposure to alternative asset classes, it's never been easier. In addition to mutual funds and exchange-traded funds that mimic popular hedge fund strategies, there are funds that invest in real estate investment trusts, or REITs, as well as all the major sectors of the commodities market. In the case of commodities, Miccolis notes, investors also have the option of investing in managed futures funds. He says they actually may be a safer diversification tool because they generally are less volatile than plain-vanilla commodities funds, and their returns tend to be less correlated to the returns of the stock market.

Diversifying beyond garden-variety stocks and bonds presents new risks and challenges for investors — unfamiliar markets, higher costs, more complex investment structures. In such an environment, it becomes even more important for an investor to work with a trusted advisor who can help in identifying and implementing an appropriate asset allocation strategy. The goal is not to create a portfolio immune to loss under every possible investment scenario, but rather one that, over the long term, will minimize the amount of risk the investor faces without sacrificing his or her investment goals.

Randy Myers is a freelance writer in Dover, Penn., whose work has appeared in Barron's, CFO, Corporate Board Member and other prominent business publications.

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Trusts that Can Pay You Back

by Randy Myers

With millions of Americans still unemployed and millions more facing hardship abroad, this is no time to skimp on charitable giving. Yet with the economy still dicey, it's easy to worry about how to give without jeopardizing your own financial security or the legacy you intend to leave for your heirs.

A charitable lead trust can help. Available in two principal forms, the "grantor-retained" charitable lead trust is particularly attractive if you are concerned that tomorrow you might need money you would otherwise like to give away today. With a charitable lead trust, money you put into the trust is used to pay a stream of income to a charity that you designate for a specified number of years, at a specified rate. Once that period expires, explains A. Scott White, a certified financial planner and president of Scott White Advisors in Fort Myers, Fla., any assets left in the trust revert to you.

In addition to offering the chance to recapture some of your money, a grantor-retained charitable lead trust also allows you to front-load the tax benefits of your charitable giving. In the year the trust is created, you can deduct the present value of all the charitable payouts it will make over its lifetime. This can be especially appealing, White notes, if you create the trust in a year when a one-time income boost would otherwise throw you into a higher tax bracket.

The tax benefits of a grantor-retained charitable lead trust are bolstered when interest rates are low, as they are now. Certified Financial Planner Leslie Beck, principal and founder of Beck Investment Management LLC in Palo Alto, Calif., explains that the lower interest rates are, the higher the present value of your charitable contributions becomes. Accordingly, you earn a bigger tax deduction.

A "non-grantor" charitable lead trust can be attractive when your concern isn't having money for yourself in the future but leaving it for your heirs. With this type of trust, any assets left after the trust's predetermined lifespan pass to your designated beneficiaries. Unlike a grantor-retained trust, this trust doesn't offer a front-loaded tax deduction. However, it does offer tax advantages for your heirs. Any growth in the value of the trust's assets, after payments to charity and beyond what the government anticipates, may go to your beneficiaries free of any estate or gift taxes. Generation-skipping taxes may apply if, for example, you name your grandchildren as your beneficiaries.

Here again, a low interest rate environment works to your advantage. The government estimates how much the assets in a non-grantor charitable lead trust will grow based on a formula that is linked to an intermediate-term bond index. When interest rates are low, that translates into a low government estimate of what your trust will earn. So, the more your trust actually earns, the bigger the chunk of money that passes to your beneficiaries free of federal taxes.

It's worth noting that this tax break becomes moot if the value of your estate when you die is less than what you would be allowed to pass to your heirs free of estate taxes. In other words, if the government only taxed estates over \$5 million, and yours was worth \$3 million, the trust would convey no estate tax benefits to you.

While there is currently no tax imposed on estates of any size, estates worth more than \$1 million are scheduled to become subject to an estate tax beginning in 2011. Meanwhile, the U.S. House of Representatives has already passed legislation that would reinstate the estate tax beginning this year, applicable to estates valued at \$3.5 million for individuals or \$7 million for couples. The Senate has yet to take action.

If either of those scenarios unfolds — Congress takes no action or embraces the House bill — the estate tax will return, and White notes that a non-grantor charitable lead trust will still be useful for those families affected by it. It will remain, he says, a good way to support a charity without sacrificing an heir's inheritance.

Charitable lead trusts are just one example of the tools you can use to support your favorite charities without jeopardizing your own financial security or your legacy goals for your family. A financial planner can help you identify giving strategies right for you, and steer you to an estate-planning attorney who can draft the appropriate documents to implement that strategy.

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Protect Your Estate

New Legislation Calls for Updating Existing Plans

by Phillips Hinch, Assistant Director of Government Relations of the Financial Planning Association

Since its inception, estate tax — those taxes on an individual's right to transfer property at his or her death, which includes an accounting of everything the deceased owns or has interests in at the date of death — has always been an issue of ("that spurred" is awkward) ongoing debate. This year in particular, the discussion will undoubtedly gain even more momentum.

At the end of 2009, many were surprised that the U.S. Senate failed to take up the House of Representatives' legislation addressing estate tax reform, leaving many confused over exactly how to plan for the future.

So what happened? When the 2001 tax cuts were enacted, Congress passed estate tax legislation via "reconciliation" rules; the crux of reconciliation is that the laws must be temporary. Over the next 10 years, the estate tax rate was slowly ratcheted down from 55 to 45 percent. Meanwhile, the exemption amount was raised incrementally from \$675,000 to \$3.5 million. Now, a decade later, the rules are set to change again. For 2010, there is no federal estate tax. But after the cuts expire at the end of 2011, the estate tax rate springs back to a 55 percent rate and a \$1 million exemption.

There is likely to be further back and forth on this issue, making the implication to taxpayers unclear. For example, Congressional tax writers are considering a change to the laws retroactive to January 1, 2010. This has many questioning the need to update an estate plan that could soon be obsolete.

"My advice is either avoid dying before Congress has made its changes, or update your documents to mitigate the impact in the event of your death," says Mark Flaherty, a CERTIFIED FINANCIAL PLANNER™ (CFP®) based in Norfolk, Va.

Getting Back to Basis

For many looking to secure their assets for their heirs, the uncertain fate of the estate tax laws is tricky. Take, for instance, the formulaic language included in many wills designed to reduce federal estate liability. A will written just a short time ago might direct the maximum amount be put in trust to minimize the federal estate tax, leaving the rest to the surviving spouse. However, with no tax in 2010, that entire amount would go into the trust, leaving nothing for the surviving spouse.

A few state lawmakers are already considering legislation to head off the potential flux of court cases that may be filed by spouses inadvertently jilted. One bill under consideration in Virginia would treat the estates of those dying in 2010 as though they had died in 2009 to circumvent the problem. Of course, there is no assurance that this will prevent a passel of other legal headaches since the IRS is not bound by the state's interpretation.

"It is absolutely essential for clients with complex family situations and transfer tax issues to come up with a plan," said Flaherty. "My role as a financial planner is to explain the potential impact to clients so they can make informed decisions and encourage them to have a conversation with an attorney."

Congress also eliminated the practice of "stepping up" basis for inherited assets for 2010. If an asset is sold for more than its basis (i.e., the price it was purchased for), there is a capital gain and taxes are owed.

Here's an example of how an average taxpayer might be affected: A widow owned a house purchased in 1970 for \$50,000 (her basis) that was worth \$800,000 at the time of her death. Her will directs her son to receive the estate, but leaves no other instructions. If this woman died in 2009, her son could have stepped up the basis of the house to \$800,000. If he immediately sold it for that amount, he would owe no capital gains taxes. However, if the woman dies in 2010, her son's basis remains \$50,000. (In tax parlance, it is "carried over" from his mother.) Now, if her son immediately sells the house, he will have a capital gain of \$750,000 and owe \$112,500 in taxes. Probably not what his mother intended.

This example may be a bit oversimplified. Estates can allocate up to \$1.3 million in basis to different assets. Still, the point is, if your will doesn't address the issue of how to allocate the basis, depending on when you die, your heirs might have to go to court to obtain relief.

If There's a Will

Here's another twist to the issue: the burden of proving basis is the onus of the taxpayer. If you can't prove it, the basis is zero, notes Flaherty. "This is a real fur ball. A person might have been compensated with company stock, but not kept good records. It can be figured out, but it won't be easy."

Taxes aren't the only reason to have estate planning documents drafted, of course. "Preparing a will falls into the 'don't be stupid' category," according to David Mendels, a CFP® professional in New York City. "One of the most important reasons for a will is to designate a guardian for your children. You don't want a court to do it."

You also don't have to be rich to take advantage of a trust, he adds. "I recommend a credit shelter trust to many clients even if there is no taxable estate. The trust can be set up to protect the assets left to a spouse or children from potential creditors. For instance, if your child, now grown, is a doctor, the assets could be shielded from malpractice claims," notes Mendels.

Federal law is not the only reason to do estate planning or revise existing plans. "People think if there's no federal estate tax, then there's no need for them to do anything," said Steve Berger, an estate planning attorney in Severan Park, Md. "Many states impose their own estate or transfer tax. If we can update a will now, we can protect and plan for next year."

Updating an estate plan doesn't have to be expensive. According to Berger, a basic document can be obtained for around \$1,000. "Times are slow, even for attorneys, and most are willing to work with clients," he says. "The important thing is to get out and plan for the situation."

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