SENTINEL TRUST COMPANY

On Watch

APRIL 2016 | VOLUME 7, ISSUE 1

In This Issue:

Total Return vs Income-Oriented Return

Identity Theft Prevention & Mitigation

Timing Can Be Everything

Total Return vs Income-Oriented Return

M. TAYLOR SCOTT, CFA
Vice President, Senior Investment Advisor

In simpler times decades ago, prudent investing for those in or approaching retirement meant an investment portfolio geared towards generating high and steady streams of income. U.S. Treasury and corporate bond interest, high dividend yields from "blue chip" companies' stock, and interest income from short-term liquid investments were the primary goals.

Structuring a portfolio in this manner gave the investor a sense of security, stability and confidence that his or her long-term financial needs would be met without having to rely on "risky" securities and their potential for appreciation. But, by taking on this income-oriented mindset, investors open themselves up to many forms of risk when they might well be better off managing around and minimizing the risks associated with a more diversified portfolio.

Story continued inside.

Risks of an Income-Only Focus

When constructing a portfolio focused on income generation, an investor typically maintains a higher exposure to fixed income investments than to equities and alternative assets like private equity and hedge funds. However, doing so tends to increase the portfolio's direct exposure to movements in interest rates. In an environment of upward moving interest rates, a fixed income portfolio will fall in value. The reason is that, when interest rates rise, your now low-yield investments become unattractive relative to newly issued bonds that come with the now higher interest rates.

An income-focused investor who wants to hold equities, but also wants to generate higher amounts of income, typically will focus on high-dividend-paying stocks. However, this focus may reduce the potential to benefit from stock appreciation. The reason is that companies paying higher dividend yields (dividend payment expressed as a percentage of the current share price) are usually in more mature industries with less promise of future growth. Rather than reinvesting earnings back into growing its business, a more mature company distributes larger dividends as an incentive to retain investors in lieu of a promise of future growth.

A portfolio of high dividend paying U.S. stocks would most likely center around more mature sectors such as regulated utilities, tobacco producers and energy, with less in high-growth industries like technology. Reducing the number of sectors in which you invest decreases diversification and increases overall portfolio risk.

In times of particularly low interest rates, an income-oriented investor might "chase" yield – investing in riskier assets in order to maintain a desired income level. This type of behavior leads investors toward lower quality bonds (higher yielding junk bonds) and higher yielding/lower quality equities. In each case, the higher income yield is necessary to attract investors to a lower quality investment.

Modern Portfolio Theory

With economist Harry Markowitz's creation of Modern Portfolio Theory (MPT) in 1952, the thought process around analyzing and investing portfolios began to change. MPT is a mathematical framework for assembling a portfolio of assets such that the expected return is maximized for a given level of risk (where "risk" is defined as variance from the average expected return of an asset).

One key MPT concept is that diversification decreases overall risk. For example, if you put all of your stock market money into the stock of a single company, your entire investment is at risk to that one company. Investing instead in, say, 30 different companies representing a variety of industries eliminates the risk that bad events in a single company or industry can wipe out your entire portfolio. Similarly, investing in a broad range of asset classes (like bonds, equities, hedge funds, private equity, real estate, etc.) and doing so around the world, reduces the risk that events in a single country, asset class, etc. can materially damage your overall portfolio.

Income vs. Total Return

So, how does MPT change the traditional focus on income generation? A heavy concentration in bonds and high-dividend stocks inherently means less diversification than a portfolio with diverse domestic and foreign equities and even private equities and hedge funds. That income-oriented approach actually may substantially increase a portfolio's overall risk. So, the notion of an income-oriented portfolio has evolved into a "total return" portfolio.

MPT provides the methodology to construct a diversified portfolio that is expected to generate a total return (including both income and appreciation), but at a lower expected risk level than a portfolio focused predominately on generating current income.

High-income individuals have another reason to focus on total return: taxes. The tax rate on interest income (43.6%) is much higher than on long-term capital gains (23.8%). Having a portion of the portfolio focused on appreciation instead of current income offers the opportunity to generate returns that can provide greater after-tax cash flow.

To summarize,

building a portfolio purely for income generation may significantly hinder your ability to manage risk and volatility. Imagine what will happen to the value of a bond portfolio if interest rates begin to rise! Using the tools of MPT, an investor may develop a strategy to maximize total return through both income generation and asset appreciation, while reducing overall risk, with the added bonus of reducing your taxes.

Timing Can Be Everything

When Mark Zuckerberg announced last December that he intended to give substantially all of his shares of Facebook stock for charitable purposes, the CPA inside of me recognized that this was not only a significantly philanthropic move, but also a potentially great tax play.

It is far more tax efficient to donate appreciated stock that has been held for more than 12 months directly to a charitable organization than to sell the stock and then donate the cash proceeds. Doing so yields a double-tax benefit: you avoid capital gains taxes on the stock sale (a potential 23.8% tax savings) and receive a charitable tax deduction for the fair market value of the shares. Gifts of appreciated property to public charities may be deducted up to 30% of adjusted gross income (AGI), with the excess carried forward up to 5 years.

Donations of shares held less than one year or of assets that might generate ordinary income if sold (e.g., interests in certain publicly traded limited partnerships, private partnerships and limited liability companies) generate less tax savings.

The contribution strategy also can work with privately held company stock. However, don't wait too long to make the contribution if negotiations are underway to sell the stock. The line can be fuzzy, but if a sale has been agreed to and all substantial contingencies of the sale have been met, it may be too late to use the contribution strategy. Even though the closing of the sale does not occur until after the contribution, the IRS may tax the capital gain to you. When contributing non-publicly traded stock, in most cases you will need a qualified appraisal and must comply with various reporting requirements.

You also can contribute appreciated stock to a private foundation, but there are additional rules and constraints, including:

- Appreciated stock gifts are deductible up to 20% of your AGI, as compared to the 30% for gifts to public charities.
- Private foundations are subject to substantial penalties (the "excess business holdings" rule) if they hold closely held stock for more than five years. And, under the so-called "self-dealing rules," the foundation generally is prohibited from selling shares back to the family or certain other prohibited persons.
- Considerable caution is required before contributing S corporation stock or interests in partnerships or limited liability companies. The foundation may be taxable on its share of the entity's business and debt-financed income.

Timing stock contributions becomes particularly tricky if your income varies significantly from year-to-year. The so-called "Pease limitations" disallow itemized deductions (which include contributions, real estate taxes, state income or sales taxes, and interest expense) by 3% of adjusted gross income in excess of $311,300 for married couples ($259,400 for singles). Pease can eliminate up to 80% of your itemized deductions. So, you may get much more benefit from contributions in relatively low income years than in high income years. Lumping two years' contributions, property taxes and other itemized deductions into one year also might increase your overall benefits.

The AGI limitations also can pose timing issues. Although contributions in excess of the AGI limitations can be carried forward, they are again subjected to the AGI limitations in those subsequent years. Contributions not used in the 5-year period are "lost." So, all other things being equal, it may be best to avoid greatly exceeding the percentage limitation if future income levels are uncertain.

So, if you have an unusually high AGI, say from the sale of a family business or large compensation payout, charitable contributions (of any kind) may not be favorable because of the Pease Limitations hurdle, thereby encouraging you to defer contributions. However, if you are very charitably inclined, contributions in a higher-than-normal year may help you to navigate the AGI limitations.

Always talk with your tax advisor before making a substantial contribution, preferably well before you are contemplating a sale. It may take time to run multi-year tax projections and you may need to understand and negotiate through some rather complex tax rules to maximize your tax benefits. Although our tax laws generally favor charitable giving, timing can indeed be everything.

DAVID ZAHN, CPA, CFP®
Assistant Vice President, Client Relationship Officer

Identity Theft Prevention & Mitigation

ANDREW B. SMITH, J.D.
Vice President, Senior Relationship Officer

Too often we receive a call from a concerned client who believes his or her identity has been compromised. Of course, we immediately take steps to help the client reduce the risk of financial, reputational or other loss. But, there are things that you can do now to reduce your risk even though you've not been compromised. Here are some easy steps to protect yourself.

1 Freeze Your Credit Reports:

The three credit monitoring bureaus allow consumers to "freeze" their credit reports for free or a nominal fee. Historically, financial professionals have suggested clients freeze their credit after identity theft. We now frequently advise our clients to freeze their credit to preempt a thief from obtaining credit if your personal data is stolen and there is attempted use before you know about it. You will have to contact the credit agency each time you seek new credit, but this small hassle is outweighed by the potential benefit. You should also freeze your minor children's and spouse's credit and recommend that your adult children do likewise.

2 Safe Keep Your Documents:

Physical documents containing private information, such as tax returns, passports and bank statements, should be in a home safe, deposit box or other secure location. Older documents should be shredded before they are discarded. If you don't have a locked mailbox, then notify the post office to hold your mail each time you are away.

3 Limit the Businesses That Have Your Information:

Your personal information should be shared only when absolutely necessary. Each time you provide your personal data to a business, the company will typically store it indefinitely. If its system is ever breached, your data may be compromised long before you learn about it. That department store charge card may provide a discount on your order, but it also makes you more vulnerable to identity theft.

4 Don't Share Information on the Phone or In Response to an Email:

Decline to provide your personal information to anyone who calls you. If your credit card company or another institution you do business with calls and asks you to confirm your identity, we recommend that you hang up and call them back at their official number (found on the back of your credit card or on their website). We advise doing this even if caller ID shows the company name or the caller sounds official. Similarly, do not click on an email link that purports to take you to a website of a company or person, even one you think you know. Instead, open a browser and go directly to the official website. Criminals are clever and can use "spoofing," which is a technique to make a phone call or email look like it is coming from another number or address. They can appear very legitimate, but may not be.

5 Stop Unsolicited Offers:

Notify the credit agencies that you don't wish to receive unsolicited offers ("pre-approval" letters) by calling 1-888-5OPTOUT (888-567-8688) or opting out online at www.optoutprescreen.com. You should also enroll in the national Do Not Call Registry by calling 1-888-382-1222 or visiting www.donotcall.gov. It also may be beneficial to check if your state has a Do Not Call Registry. (For example, the Texas registry is online at www.texasnocall.com.)

These suggestions, combined with a little common sense, represent some of the simplest actions that provide an immediate benefit to your privacy.

6 Use Opt-out Options:

Instead of throwing away the annual privacy notices you receive from financial institutions, consider calling the number on the form to limit sharing of your data. Many businesses sell your information unless you opt-out. Similarly, look for opt-out opportunities whenever you open an account (financial or otherwise) online. Again, limiting the number of organizations that have your information reduces the risk of your identity being compromised by others' security breaches.

Short of going "off the grid" entirely, nothing can totally stop identity theft. However, taking these simple steps before a problem arises can reduce and limit your risk.

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

Contributing to this issue:

Anthony J. DeToto

D. Fort Flowers, Jr., CFA

Lissa Gangjee, J.D., CFP®

Ross W. Nager, CPA

M. Taylor Scott, CFA

Andrew B. Smith, J.D.

David Zahn, CPA, CFP®

For additional information about the topics presented in this newsletter, or to be placed on our mailing list for future editions, please contact Anthony DeToto at adetoto@sentineltrust.com or call 713.559.9578. You can find electronic copies of our past quarterly newsletters at www.sentineltrust.com/publications/on-watch/.

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

www.sentineltrust.com

Sentinel does not provide tax advice. Any discussion of tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding any tax-related penalties. This communication is for informational purposes only and nothing herein should be construed as a solicitation, recommendation or an offer to buy or sell any securities or products.