Sentinel Trust Company

On Watch

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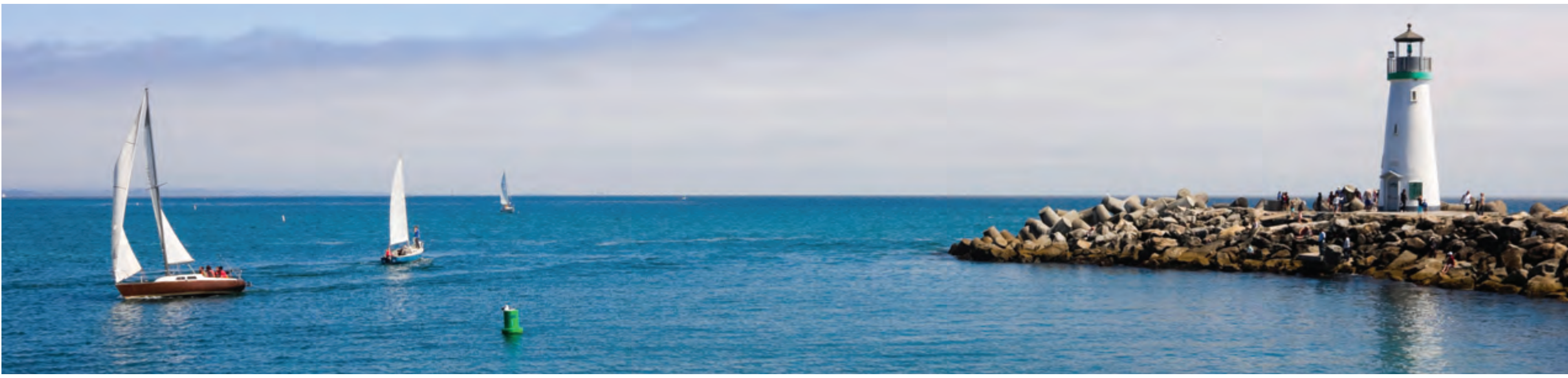

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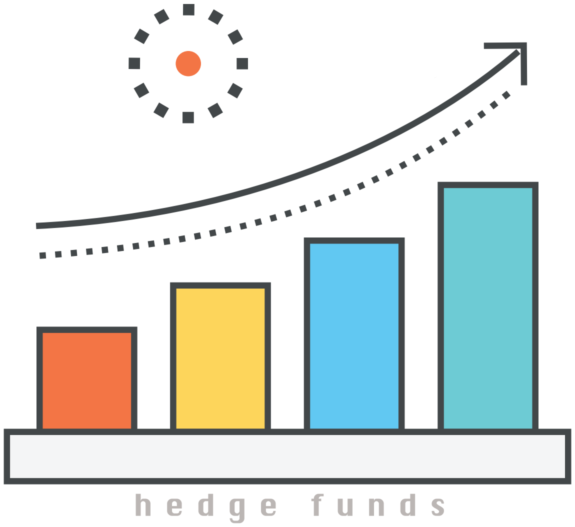

A Hedge Fund Primer

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Created in 1949 by Alfred Winslow Jones, the first hedge fund was considered a conservative investment approach executed by merging two more speculative investment tools.

Jones started with a portfolio of publicly traded stocks ("long" positions). He then sold a similar amount of stocks that he did not own ("short" positions). This substantially eliminated overall market risk because, if the market went up, the increased value of his long positions would be offset by a decline in the value of the short positions, and vice versa. However, if he was successful in buying long positions in "good" companies and/or he sold short shares of "bad" companies, then he would make money for the investors.

It took almost 20 years, stellar performance and a magazine article to bring notoriety to this innovative investment idea. Today, about 68 years later, investors worldwide consider hedge funds to be a key component of a diversified investment portfolio and have $3.22 trillion in the asset class.

Story continued inside.

Cover story continued.

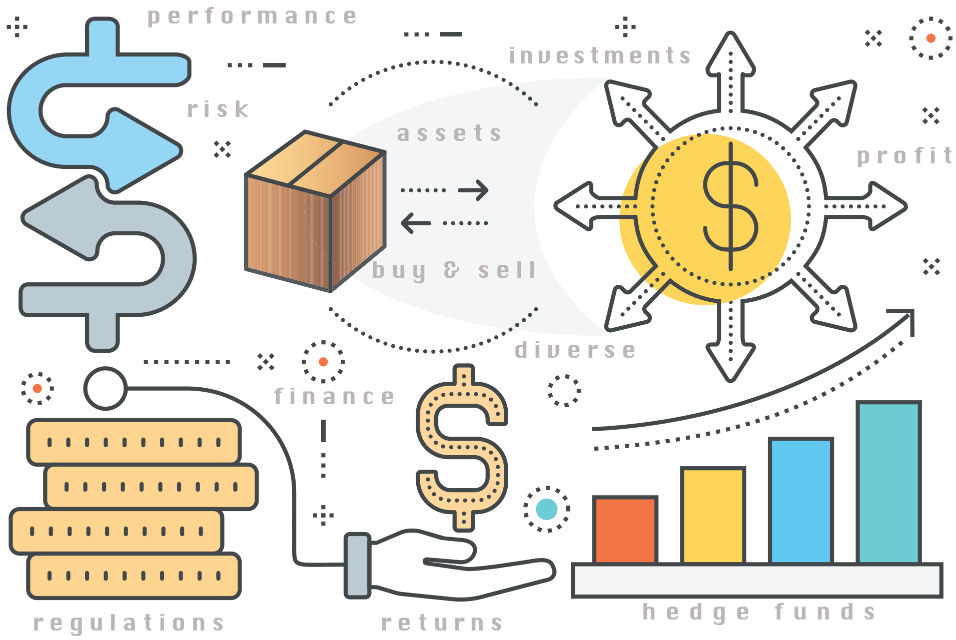
Hedge funds have evolved to include:

- So-called "long/short" strategies similar to Jones' original approach of buying stocks that are expected to increase in value and selling (short) positions that are expected to decrease in value;
- Event-driven strategies that exploit potential changes in the corporate structure of companies, like mergers and bankruptcies;
- "Relative" strategy approaches that seek to profit from pricing discrepancies in similar securities; and
- "Macro" strategies that trade opportunistically around major economic trends and events.

Why Own Hedge Funds?

Including a variety of hedge fund strategies in your portfolio diversifies your portfolio more than "simply" owning a variety of stocks and bonds. That diversification can reduce overall volatility, generate returns that are not correlated with or dependent upon the movement of the public stock markets, and mitigate downside risk.

Over the past 10 years, hedge funds have outperformed the S&P 500 index (7.7% versus 4.7% through December 2016), although they have underperformed over the last three- and five-year periods. But, comparisons to the stock market are an inappropriate way to evaluate hedge funds. Why? Because the objective of investing in hedge funds is to generate returns that are not directly related to the stock market and to do so with less volatility than the stock market. Indeed, hedge fund volatility has decreased from 10% in 2011 to 4% today. Lower volatility means lower risk.



Despite the attributes hedge funds contribute to a well-diversified portfolio, not all investors have the ability to invest. An investor must be an accredited investor (investors with higher income and a large amount of assets) and institutions must have at least $5 million dollars to qualify for investing in hedge funds. Also compared to exchange traded funds (ETFs) and mutual funds, hedge funds tend to have higher fees, less transparency at the asset level and less liquidity.

Fees, Fees and More Fees

Hedge funds typically impose a significantly higher fee burden than more traditional asset classes, like stocks and bonds. Hedge funds typically charge an annual management fee calculated as a percentage (often 2%) of the value of assets under management. Most also charge a "performance" fee, usually 20% of the fund's investment returns over a stated hurdle rate of return. This performance fee is the defining characteristic of a hedge fund: it motivates the hedge fund manager to generate superior returns, and it is intended to align the interests of the manager and investors by more than just the flat-rate-management fees typically charged by traditional managers.

Given the risks associated with the lack of transparency of many hedge funds (and the potential for a devastating event, like a Madoff fraud or headline-grabbing investment miscalculation), it is wise to greatly diversify your hedge fund investment. That may mean spreading your hedge fund money among 25-30 different strategies and managers. Unfortunately, many hedge fund managers require a minimum investment of $1 million, or even $5 million, putting them out of the reach of all but the wealthiest investors.

So, many investors own hedge funds via a "fund of funds." A fund of funds pools investors' money, thereby enabling the fund of funds to invest in many strategies and managers. Each investor owns a small percentage of each of the underlying funds in the pool, so he or she is diversified. Unfortunately, most funds of funds impose yet another level of management and performance fees to compensate the sponsor. For its clients, Sentinel eliminates this additional level of fees by similarly pooling clients' funds, but not charging an additional fee for its sponsorship role.

Selecting the Right Fund(s)

Whether investing directly in hedge funds or via a fund of funds, it is important to conduct the proper due diligence. Looking at historical performance and the track record is important, but of course, past results do not guarantee future performance. The investor also should look at the benchmark to which the fund's performance will be compared since improper benchmarks can lead to incorrect analyses and angst in the future. Additionally, insights can be gleaned by taking a close look at the management team and its industry/strategy experience, tenure and consistency with the style of investing.

The Future of Hedge Funds

Despite disappointing performance over the past few years, the size of the hedge fund industry measured in assets under management has been steady and even grew by approximately $200 billion from 2015 to 2016.

Fees have been decreasing steadily, particularly the annual management fee. As hedge fund managers grow, they can scale their businesses more efficiently, thereby enabling a lower management fee. The industry also has experienced increased competition. More managers are entering the market, creating pressure to reduce fees to attract outside capital.

There are over 14,500 hedge funds, so picking the correct funds is a daunting challenge at best. Returns vary across strategies. There is an abundance of new fund launches (approximately 1,000 hedge funds launched in 2016) as well as fund closings (approximately 1,000 closed in the same time period). Given the complexity of the hedge fund world, investors should be careful, thoughtful and prudent in their approach to this dynamic asset class.

Putting Legacy 401k Accounts to Good Use

When we meet with clients in their homes, they often hand us stacks of documents and ask if we can help tie up loose ends. Inevitably, we find statements for old 401k retirement accounts amassed from prior employment. Typically, these 401k accounts (and perhaps some old individual retirement accounts) represent a very small fraction of the family's wealth, but they might offer attractive planning opportunities that often are missed.

ANDREW B. SMITH, JD
Vice President and Senior Relationship Officer

Gift to Charity

Individuals over age 70-1/2 may make a direct gift up to $100,000 from individual retirement accounts (IRAs) to charitable organizations each year. Such a gift satisfies up to $100,000 of your required minimum distribution (the mandatory distribution that must be made each year beginning after age 70-1/2). The distribution to charity is not taxable as income to you, and you don't get a charitable deduction for it. However, the income tax consequences may be better than taking the money (resulting in taxable income) and then giving it to charity (resulting in a deduction). The reason is that the benefit of the deduction may be less than the tax on the distribution because:

- Itemized deductions (including charitable deductions, state taxes, mortgage interest, etc.) are disallowed by a percentage of adjusted gross income;
- Contribution deductions are limited to a percentage of your adjusted gross income; and
- Various other detrimental tax consequences are imposed as adjusted gross income is increased.

To obtain these benefits, the 401k must first be converted to an IRA.

Not all charities are eligible. For example, donor-advised funds and private foundations are not eligible recipients. Also, the funds must not pass through your hands; they must be transferred directly by the IRA trustee to the eligible charity.

To determine when to recommend this option to clients, we consider a client's age, size of the 401k, current level of required minimum distribution, other assets available to give to charity, desired charitable recipient and additional factors.

Conversion to Roth IRA

For clients who have a "regular" 401k (meaning one for which distributions will be taxable income) we consider whether it is beneficial to convert to a Roth IRA. This conversion requires the owner to report the account value as ordinary taxable income. That horrible front-end consequence may be offset by two Roth benefits:

- Subsequent income and appreciation within the plan is not taxable and can be withdrawn tax-free in the future, and
- There are no required minimum distributions from Roth IRAs during the owner's life. Rather, the beneficiary subsequently must take required minimum distributions over their life expectancy, permitting a longer time period for tax-free earnings.

The following are some of the factors we consider in evaluating the appropriateness of this technique for a client:

- **Age** – because tax is paid upfront, younger individuals are much better candidates because they have many more expected years to recover the cost.
- **Income** – a Roth IRA conversion is more attractive when the account holder has depressed ordinary income so we can take advantage of a lower effective tax rate on the conversion.
- **Asset values** – when the investments in the 401k are trading below their fair value, the expected tax-free return after the Roth IRA conversion is higher.

Legacy 401(k) and IRA accounts can provide attractive opportunities to advance your family's financial goals with optimal tax results. Of course, you should confirm any conclusions with your tax advisor, but the starting point is digging out those old account statements.

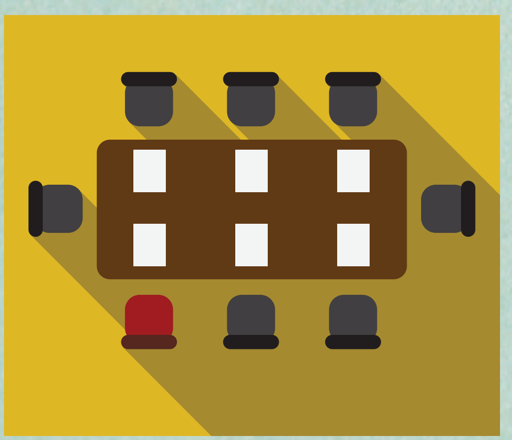
Becoming a non-family director of a family business

A simple internet search reveals numerous articles about the benefits of independent directors on family business boards. They can provide additional industry knowledge, leadership experience, and important supplemental skill sets (e.g., finance or technology). Despite all the writings on the subject, there is a dearth of advice for those actually considering serving on family business boards.

In the family business context, an "independent director" is **not**:

- a current or former member of management,
- related to the family,
- a friend of a family member, and
- serving the family or the business in a different manner (e.g., as an attorney or accountant).

Any of these relationships might impact the reality or perception of the individual's independence and objectivity.



Why Agree to Serve?

Intellectual stimulation is among the most important reasons to serve. The long time horizon of many private family businesses with a lesser need to focus on short-term goals allows the board to focus on truly strategic questions and decisions. Implementing those decisions in the context of multi-generational management and culture allows board members to participate in a truly exciting endeavor.

Serving on a family business board can further your experience by being around successful entrepreneurs who are working through both business and succession issues in a family-leadership context. Because family dynamics are always a part of family business, serving as a director is often challenging and interesting.

Why Say "No?"

You should understand the expectations of the family owners and make sure that you will be able to add value within the context of those expectations. If you are not able (or allowed) to add value to the enterprise, then you should step down.

A director also must pay close attention to intra-family strife that may raise potential liability exposure and effectively make the job impossible to do.

Note that, while independent directors are almost always compensated, financial considerations should never be a key factor in deciding whether to serve. If the director fee will be important to your standard of living, your independence and objectivity may suffer. However, potential legal liability must be a concern. Make sure that the business has sufficient net worth and insurance to protect its board members from potential liability.

Performing as a Director

All corporate directors are expected to bring skills and experience to the board table so they can put corporate issues into the appropriate perspective and context. A director of a family business needs to understand the heightened need for diplomacy, especially around issues involving the complex relationships between the business and the family. Often, the most critical skill in this regard is knowing which battles to choose.

While prior experience with family businesses is helpful, often the most important background is mentoring and coaching. In order for a business to remain in the same family, generational transitions need to be successfully navigated. No one outside the family is in a better position to advise and teach than an independent director.

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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.