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Reevaluating Your Portfolio

The market changes. Companies change. Investments change. Your needs and goals change. That's why it's important to see - at least once a year - if your investment portfolio needs to change, too. Here is a disciplined approach to reevaluating your portfolio.

1. Review the value of your investment portfolio.

Have your investments lost value? Gained value? By how much? Answering these questions will give you the big picture overview of your portfolio's status.

2. Check how your portfolio is performing in comparison to benchmarks.

If you simply review the absolute performance of your investments, you may feel you've done very well or quite poorly. However, what really matters is how your investments have performed relative to their respective benchmark indexes. There are a number of indexes that can be used as benchmarks against which you can measure your investments' performance.

3. Compare the individual investments in your portfolio against comparable investments in the same asset class.

Step 2 will give you an idea of how your particular investments performed against their relative indexes, while Step 3 will help you understand how individual

investments similar to yours have performed. Compare your individual investments against comparable investments in the same asset class.

Ensuring that you're comparing similar investments can be difficult when you're looking at individual investments. Please call if you need help determining investments to use for comparison purposes.

4. Ensure that your investments remain consistent with your established goals.

As your life circumstances change, so should your investments. If your financial goals include sending children to college or saving for retirement, you'll want to transition your assets into more conservative investments as you get closer to your goal.

You'll also want to evaluate whether your asset allocations remain consistent with your financial goals. As investments gain and lose value, your asset allocations can change. You may need to adjust your investments if uneven gains and losses have disrupted your asset allocations.

5. Make any necessary tweaks to your investment allocations.

Once you've gone through steps 1 through 4, you should know what changes are needed in your portfolio. To make those changes, you can:

- Sell off investments from overweighted asset categories and use the proceeds to purchase investments for underweighted asset categories.
- Purchase new investments for underweighted asset categories.
- Alter your contributions (if you make regular contributions to your investment portfolio) so that more investments go to underweighted asset categories until your portfolio is back in balance.

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Passing on Valuable Life Lessons

You're looking for an effective way to get your heirs to do what you think is best for them, for the family, and for the world. Is an incentive trust the right vehicle to accomplish that?

An incentive trust is much like a traditional irrevocable trust, except that it sets specific conditions on trust distributions. Some people establish incentive trusts to make sure beneficiaries stay in the family business. Others want to encourage higher education or public service. Some want to discourage behavior - laziness, reckless spending, or drug use. Still others want to encourage beneficiaries to get married and raise a family.

Incentive trusts have advantages and disadvantages

If you think an incentive trust may be a useful part of your estate plan, consider the advantages and disadvantages.

The advantages of incentive trusts include:

- If you write the conditions for disbursement properly, they provide objective criteria for when and how to make these disbursements.
- They encourage beneficiaries to behave in ways that are important to you.
- They allow you to condition disbursement on your beneficiary's age, so you can decide when he/she is old enough to responsibly manage the inheritance.
- They can help you accomplish goals through your beneficiaries, such as continuing the family business or pursuing philanthropic interests.

But there are also disadvantages:

- While incentive trusts allow you to specify conditions for distributions, they restrict the ability of trustees to make different decisions if new circumstances arise.
- Incentive trusts can cause resentment among beneficiaries, who may feel it is not your place to tell them how to live their lives.
- Encouraging goals you think are important may cause beneficiaries to neglect other good opportunities. For example, you may want a beneficiary to start a business, but he/she may be better suited to another career choice.
- Incentive trusts may be plagued by the law of unintended consequences. How can you foresee the future long after you've died? You may instruct the trust to pay out a stipend for your beneficiaries to go to school, but that may encourage them to become "professional" students.

- Because incentive trusts are often more complicated than traditional irrevocable trusts, they may be more expensive to establish and maintain.

What to think about

There are a number of issues that could affect the design and implementation of an incentive trust. Consider these points carefully:

- **Goals** - What behaviors do you want to promote? Incentive trusts are often created to encourage beneficiaries to pursue higher-education degrees. Discouraging reckless consumption and unproductive behavior are other common reasons behind incentive trusts. Think about what matters to you and your beneficiaries. What goals are fair and reasonable for you to expect your beneficiaries to achieve?
- **Coordination with your estate plan** - Incentive trusts are just one component of an estate plan. Decide whether you want to create a separate incentive trust or build incentive clauses into a trust designed for another purpose. Make sure the incentive trust doesn't conflict with or detract from other components of your estate plan.
- **Duration** - How long do you want the incentive trust to last? For grantors with substantial wealth, a trust may span many generations. Can you realistically set expectations for beneficiaries who aren't even born yet?
- **Beneficiaries** - Who will benefit from the monies disbursed from the incentive trust? Considerations here are similar to those for any kind of trust: who do you include and exclude?
- **Trustee designation** - The trustee of an incentive trust typically has a more difficult job than the trustee of a simple traditional trust, since he/she must decide when beneficiaries have met the conditions you specified. Make that job easier by writing conditions that are objective and easily measured.

How to prepare an incentive trust

If you decide an incentive trust may be right for you, you should:

- Sit down with your beneficiaries and trustee to discuss your goals for the incentive trust. The likelihood that your beneficiaries will later resent the incentives is greater without this discussion.
- Build flexibility into the trust to accommodate changes in circumstances. This will mitigate unintended and undesirable consequences.
- Ensure that the conditions you want to include comply with state and federal laws.

If you don't want to establish an incentive trust, you can limit each beneficiary's inheritance to an amount that isn't likely to encourage reckless consumption and

unproductive behavior. Another alternative, if your interest lies in philanthropy, is to establish a private foundation and name your beneficiaries as board members. That way, your money is still controlled by your beneficiaries, but it is put to charitable use.

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A Look at Coverdell ESAs

If you're looking for a tax-advantaged way to save for your child's college education, consider Coverdell education savings accounts (ESAs). The basic features of ESAs include:

- Annual contributions of $2,000 per beneficiary under age 18 can be made to an ESA. This amount is in addition to limits for other types of IRAs. After December 31, 2010, the annual limit will decrease to $500.
- Contributions aren't tax deductible, but earnings grow tax free as long as distributions are used for qualified education expenses.
- Qualified education expenses include tuition, certain room and board charges, books, and other supplies. Tax-free distributions can also be used to pay elementary and secondary school tuition and expenses, including tutoring, room and board, uniforms, and extended day care programs, and to purchase computer technology and equipment, including Internet access and services.
- Eligibility to make contributions is phased out at adjusted gross income levels of $95,000 to $110,000 for single taxpayers and $190,000 to $220,000 for married taxpayers filing jointly. If your income exceeds those limits, you can ask other relatives to contribute for your children. Your child can also make the contribution to his/her own ESA, since there is no earned income requirement for contributions.
- Corporations and other entities can make contributions to ESAs, regardless of their income.
- Contributions can be made until April 15 of the following year.
- Distributions must be made before the beneficiary turns 30. Any funds not used for qualified education expenses are subject to normal income taxes

and a 10% federal income tax penalty. However, the ESA balance can be rolled over to another ESA for different family member.

- Contributions can be made to both an ESA and a section 529 plan for the same beneficiary in the same year.
- You can claim the Hope scholarship credit or lifetime learning credit in the same year tax-free distributions are taken from an ESA, as long as the credit is not claimed for amounts paid with the tax-free distributions.
- For special-needs beneficiaries, contributions can now be made after age 18, and tax-free distributions can be taken after age 30.

Keep in mind that many of the provisions related to ESAs are scheduled to expire in 2011 unless further congressional action is taken.

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Taking Advantage of the 0% Capital Gains Tax

In 2008 to 2010, the capital gains tax rate for individuals in the 10% or 15% tax bracket is 0% (down from 5% previously). After 2010, the rates will revert to pre-2001 rates, unless further legislation is passed. Who will benefit from this reduction?

Many parents with children in college or near college age in 2008 to 2010 were planning to gift appreciated investments to children, who could then sell them during these years and pay 0% tax on any gains. However, legislation that went into effect last year raised the age limit for application of the "kiddie tax" to all children under age 19 (previously under age 18) and to students under age 24, starting in 2008. The "kiddie tax" refers to the manner in which unearned income is taxed for children. In 2008, the first $900 of unearned income is tax free, the second $900 is taxed at the child's marginal tax rate, and any remaining unearned income is taxed at the parents' marginal tax rate.

Thus, it will be difficult for individuals with students under age 24 to take advantage of the 0% capital gains tax rate. However, if you have older children in graduate school, medical school, or law school, you may be able to sell

investments and pay 0% capital gains tax. Another alternative is to make sure your student has significant earned income. If the earned income of an individual over age 17 exceeds half of his/her support, the "kiddie tax" does not apply. Scholarships are not considered for this test.

Individuals retiring in 2008 through 2010 may be in the best position to take advantage of the 0% tax bracket. With no or low salary, even high-income individuals may find themselves in the 10% or 15% tax bracket in the early years of retirement, although it may be necessary to delay benefits from pension plans and Social Security to do so. If that is the case, this would be a good opportunity to sell highly appreciated assets without incurring any taxes.

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The Basics of Earnings

When evaluating a stock, you'll typically look at a variety of historical figures. One of the most important is earnings, which is also used as a basis for several other important statistics.

From an accounting standpoint, earnings are calculated by subtracting operating costs, taxes, and preferred stock dividends from revenue. Those earnings are typically divided by common stock shares outstanding to come up with earnings per share, or EPS. EPS is a convenient way to compare earnings over a period of years, so upward or downward trends can be identified.

The price/earnings ratio, or P/E ratio, is calculated by dividing the stock's price by its EPS. It's one of the most common measures of stock value, both for individual stocks and the overall market. It basically indicates how much investors are willing to pay for a dollar of the company's earnings. P/E ratios can be calculated using different earnings numbers. Trailing P/E ratios, which are typically reported in newspapers, use earnings per share for the most recent four quarters, while forward P/E ratios use forecasts of future earnings per share.

For individual companies, investors' expectations regarding future earnings affect the P/E ratio. Confidence that a company will improve its profitability or remain profitable generally results in a higher P/E ratio. If profits are threatened or weak, the P/E ratio is likely to drop. Higher forward P/E ratios indicate investors regard the company more highly and expect the company to have good future prospects. P/E ratios for the overall market change based on broad market conditions and investors' views about how desirable stocks are compared to other investments. P/E ratios can fluctuate significantly over time and among companies and industries.

A company's growth prospects can be evaluated using the price/earnings growth, or PEG, ratio, which is calculated by dividing the P/E ratio by the company's projected earnings growth rate. A PEG ratio of one is considered standard, meaning its growth rate is incorporated in the stock's price. A PEG ratio higher than one means the stock is trading at a premium to its growth rate, while a ratio less than one may mean the stock is undervalued.

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