



PROBITY ADVISORS, INC.[®]

A MEMBER OF WEALTH SERVICES ALLIANCE[®]

Family Wealth Preservation

CONTROL IS BETTER THAN OWNERSHIP

Over the last four decades, I've learned that **control** is better than ownership. This may seem counterintuitive at first. In our greed-driven world, "the person who dies with the most toys wins" culture, we're taught that owning as much as possible is a good thing. However, anything that we **own** can be taken away from us. As an example, we have observed a number of clients who, having inherited assets in their personal names, have lost some or all of those assets in divorce or other forms of litigation and bankruptcy. In contrast, those assets that we control rather than own, we can use for our personal benefit, but potential litigants have a hard time accessing.

Recently, we had a case where a client's spouse filed for divorce, and then tried to claim our client's inheritance as a part of the divisible estate. Even though our client lived in a common law state that generally allowed this type of division, the court was ultimately unable to touch his inheritance due to the manner in which it was held. You see, our client didn't **own** the assets. The assets were held in a trust. As beneficiary and trustee, our client has broad control over the assets; however, since he doesn't **own** them, they can't be taken away. In a lawsuit, a judgment creditor can only take what you **own**. And, at the end of your life, the estate tax system can only tax what you **own**. In some states, a trust can last forever, so in some jurisdictions, trusts can be designed in which wealth can be held for the benefit of family members for generations without having to be fed through the death tax ringer at each generational level.

In some respect, the primary goal in estate planning is to structure a plan that balances the benefits and detriments imparted by the techniques used to create control against those associated with outright ownership. Creating a "controlled" estate broadly entails two components: the legal form in which the assets are held; and the governance mechanism used to administer the assets in a manner consistent with the benefactor's desires. While the legal form traditionally gets the majority of attention because it is the instrument that actually protects the assets, the governance structure ultimately dictates the long term success of the plan. As we discussed in the first part of this series, the key to the continuation of wealth through generations is establishing a good, self-perpetuating system of family governance.

For many of our clients, planning family governance isn't easy. Once the patriarch or matriarch works so hard to build wealth, it's difficult to envision giving up control - even at death. In order to truly protect and maximize the estate, however, giving up control at some point must be anticipated. In the case of an autocratic estate builder, he or she might retain their control up until the very end, ultimately passing control under very strict rules to an institutional trustee. While this might very well perpetuate financial wealth, it will most certainly impede the perpetuation of intellectual wealth. In the absence of strong family governance, there is no facility by which the originator of the trust can educate the beneficiaries to their rights and responsibilities. While the estate's legal form may contain hundreds of pages of formal documents, conflicts and lawsuits are born from familial distrust and the differences in interpretation of such legalese. A family that has established a well thought out family governance structure has a far greater

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Market Commentary

Global equity and bond markets rallied strongly through much of the third quarter, powered by stronger than expected second quarter corporate earnings and improving economic and housing market fundamentals. The S&P 500 ended the quarter up 8.6%, building on its momentum from early in the year. Despite improving market sentiment and economic data, investors shouldn't assume the market will continue to power higher without a pullback. As we head into the historically weak September and October months, investors may use the slightest negative news to take some profits off the table, setting the stage for a market correction.

Headline numbers of 76%, 52%, and 33% returns in emerging market stocks, the S&P 500, and high yield corporate bonds have moved many investors off the sidelines in recent months hoping to take part in the action. If we dive deeper into these numbers we see that over 75% of the gains in these asset classes were made prior to the end of the second quarter, which is typical of performance off of market bottoms. The market was positioning itself ahead of improving fundamentals and corporate earnings, which it received in the form of improving manufacturing activity in the ISM Manufacturing Index and the Empire State Manufacturing Index. The ISM Manufacturing Index came in at 52.9 in August, up from 44.8 in June. The Empire State Manufacturing index rose to 12.1 in August, up from -9.4 in June. On the housing front, sales and prices were both up as existing-home sales rose to 5.24 million units in July, up from 4.89 million in June. Housing prices also showed improvement with the Case-Shiller Index up 1.4% in June on a month-to-month basis. Corporations were successful in reducing operating

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TREASURY BONDS: A BUY OR SELL?

Prices for treasury bonds have fallen in recent months as investors moved out of bonds and into stocks. As a result, bond yields, which move inverse to bond prices, have risen. With 30-year treasury yields above 4% and 10-year treasuries above 3%, is now the time to buy?

U.S. treasury investors were big winners in 2008 as markets slumped, with the iShares Barclays 20+ year bond ETF (TLT) rising +28% while the S&P 500 declined -38.5%. Now, a recovering economy has pushed the S&P 500 up 50% from its March lows while TLT has fallen about -20%. Investors may view this as a buying opportunity; however, we believe it is too early to move into treasuries. Historical yields on 30-year and 10-year treasuries are 7.6% and 6.4%, respectively. This suggests bond prices have room to fall in order for yields to revert to their historical averages, serving as a buying signal.

Looking ahead, there will likely be more favorable opportunities to buy treasuries. The combination of massive stimulus spending and renewed economic activity has the potential to spark higher inflation down the road. Higher inflation may lead investors to demand greater compensation for the erosion in purchasing power brought about by inflation, pushing yields higher. Even if inflation remains in check, investors may decide to charge a premium for the U.S. government's declining creditworthiness brought on by our expanding debt load. Furthermore, as the global economy improves, investors will begin to compete to borrow money. This competition for debt allows bond buyers to demand higher rates than during recessionary periods. Since high-grade corporate debt and treasuries compete against one another on the margin, treasury rates may have to rise in order to attract buyers to fund the government's activities.

Regardless of which scenario plays out, it would appear rates will rise in the future, creating better buying opportunities than those that exist today.

DOES A ROTH IRA CONVERSION MAKE SENSE?

A lot of buzz has been building around changes coming to Roth IRA conversions in 2010. For one year only, taxpayers will be allowed to convert their traditional IRAs to Roth IRAs regardless of their income level. Before you decide to take advantage of this one year only opportunity, consider if a Roth IRA conversion makes sense and what the implications are for your long-term tax planning needs.

Generally speaking, tax advantaged or qualified accounts take two forms: tax-deferred and tax-free accounts. Tax-deferred accounts, like traditional IRAs, allow taxpayers to make tax-deductible contributions to the account, accumulate funds tax-free, and be taxed only upon withdrawal of the proceeds from the account. Tax-free accounts such as Roth IRAs are funded with after-tax dollars, allowing for tax-free

accumulation and withdrawals. Individuals with incomes above \$100,000 had previously been prohibited from converting to Roth IRAs. Now the recent IRS regulation change gives them a limited, one-time opportunity to convert their tax-deferred IRA to a tax-free IRA—but look before you leap.

The sensibility of converting a traditional IRA to a Roth is highly specific to the individual taxpayer's current and future tax situation. A conversion to a tax-free account triggers an immediate tax liability. Take note that tax rates will likely go up in 2011, so you may be paying taxes on the conversion at a higher tax bracket. The rule change does ease the tax burden somewhat, allowing you to spread your tax liability over two years instead of one. Regardless of when you choose

to pay your tax bill, make sure you can cover it from funds outside of the conversion principal. If you choose to tap your conversion funds to pay the taxes, you diminish the long-term tax-free growth. Since a traditional IRA requires a minimum distribution starting at age 70 1/2, individuals need to consider what their adjusted gross income (AGI) and marginal tax rate will look like in the future. If AGI tax rates are anticipated to be lower, then sticking with a traditional IRA may be the right choice. Alternatively, if tax rates are rising or AGI increases, then a Roth conversion might be preferable. Finally,



consider when you will be making withdrawals. A conversion to a Roth IRA starts a new clock on withdrawals, which means in order for you to gain the full benefits of the Roth IRA you will have to wait five years before withdrawing funds.

There is no one size fits all solution to the Roth IRA conversion puzzle. If all the changes seem overwhelming, don't hesitate to give us a call. Our certified financial planners have the in-depth knowledge of the IRA marketplace to help you decide if a conversion is right for you. They can analyze your current tax situation, model potential scenarios, and suggest the optimal mix of taxable, tax-deferred, and tax-free accounts to meet your retirement needs.

SMART 401K INVESTING

It's time to re-take the reins on your 401k savings plan. Stock and bond markets have rallied strongly in recent months leaving many investors who fled to the safety of cash to play catch up. Don't let the market's robust performance get the best of you by leading you to take on too much investment risk in order to recapture your losses. Through dollar-cost averaging, portfolio diversification, low fund fees, and your employer's 401k match, you can get your retirement plan back on track.

DOLLAR-COST AVERAGING

Dollar-cost averaging is a savings method that allows you to set aside regular pretax amounts from your paycheck at fixed intervals. In a 401k plan, regular payroll deductions allow for a consistent way to save for retirement. In addition, dollar-cost averaging takes the emotional component out of investing, minimizing our natural tendency to buy more during market rallies and sell into bear market declines.

PORTFOLIO DIVERSIFICATION

Most investors tend to focus only on the U.S. equities market, resulting in an over allocation of their investment dollars to this market. Keep in mind that including even a small amount of foreign and emerging market stocks and corporate and municipal bonds can help you to reduce your overall risk. By sprinkling your investments over multiple asset classes, you reduce the negative impact on your portfolio of large declines in any one given market.

WATCH THOSE FUND FEES

Fund fees can take a big bite out of investment returns. Make sure you consider your fund's management fee as part of your fund selection process. Consider exchange-traded or indexed funds which charge low fees. The less you pay in fees, the more money that stays in your pocket.

COMPANY MATCH

Maximize your company's match if you are fortunate to have one.

A matching contribution gives an instant boost to saving for retirement. The dollars can really add up over time as you enjoy tax-deferred growth until retirement.

For our 401k plan participants, we consistently stress the importance these factors play in successfully saving for retirement. We provide our plan participants with customized portfolio solutions to meet their investment time horizon and risk tolerance needs. Through extensive research we generate the optimal mix of stocks and bonds while ensuring our portfolios reflect the most timely market information. In addition, we strive to keep more money in our plan participants' pocket, using low cost alternatives to meet their investment needs. Keep these steps for successful 401k savings in mind as you reposition your plan to meet your retirement goals.



FIGHTING INFLATION IN YOUR PORTFOLIO

Aggressive government and monetary policies are setting the stage for potentially higher inflation down the road. Now is the time to start thinking about how to protect your portfolio from rising prices. To help you plan ahead we've dug into our research vault and uncovered several investments that have historically improved portfolio returns during inflationary periods.

COMMODITIES. Many investors think that gold and silver provide good hedges against inflation, but they actually perform better during times of crises. Instead, focus on commodities tied to industrial production such as oil, aluminum, copper and zinc for inflation protection. As the economy recovers, demand for these raw materials should pick up, leading to higher prices.

STOCKS. Companies have the ability to fight inflation by raising prices, which, as a shareholder, means more money in your pocket. Historically, small-cap stocks have outperformed their larger-cap peers since they have greater flexibility to raise prices. And don't forget dividends! Dividends play an integral role in overall stock performance, contributing as much as 40% to a stock's total return.

REAL ESTATE. Real estate has traditionally proved to be a good hedge against inflation. Investors have historically flocked to this asset class during inflationary periods as buyers demand "real" assets as opposed to "paper" assets which can be created at will by the federal government. In the real estate space you may want to consider real estate investment trusts. REITs have the ability to pass through a majority of their cash flows to investors, thus providing attractive yields.

SHORT-TERM CORPORATE BONDS. Short-term bonds are less sensitive to increases in interest rates since they have a shorter maturity, allowing you to quickly capture higher yields once interest rates start moving up. In the high investment grade bond market; the iShares Barclays 1-3 year bond ETF offers investors a maturity of 1.98 years and a yield of 3.80%.

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("Market Commentary" continued)

expenses. Second quarter earnings showed more than two-thirds of S&P 500 companies beating earnings estimates.

With markets moving higher, many who had been out of the market earlier this year have been tempted to move aggressively back in, so as not to miss the rally. We however urge caution at this point as the market appears to be ahead of itself, pricing in a v-shaped recovery. That is it expects the economy to quickly bounce back to pre-recession growth levels. That remains to be seen as the economy has to wrestle with a still recovering housing market and weak employment outlook. The housing market has to this point been propped up by low interest rates and first-time homebuyer credits, which are nearing the end of their lifecycle. Unemployment stands at 9.4%, but underemployment stands at 16.3%. Even if businesses begin to hire early in 2010, it will take many months for the ranks of the unemployed to shrink. As investors begin to ask themselves the hard questions about the strength of this recovery, the stage is set for a correction in the fourth quarter.

From an investment strategy perspective we will keep both the short-term and long-term headwinds in mind as we continue to position our investment portfolio towards an early stage recovery. We still see value in high quality large cap equities and short-term investment grade corporate bonds. On a sector specific level we continue to like the industrials, energy, and information technology sectors, historically strong performers early in an economic expansion.

("Fighting Inflation" continued)

Although the economy is still in the early stages of recovery, deflationary forces remain greater than inflationary forces. The massive amount of global stimulus pumped into the system along with an accelerating recovery could catch regulators off guard and has the potential to lead to inflation in the future. Should we see re-inflation, keep these investments on your radar to help ensure your portfolio maintains its buying power.

("Control Vs. Ownership" continued)

probability of achieving the goals of a harmonious transition and actively engaged beneficiaries long-term.

The real assets of a family are its individual members. This fact is well worth remembering. In order to effectively control and grow all forms of family wealth, each family member needs to be engaged in wealth perpetuation. Intergenerational participation in the estate's governance provides the most direct means of propagating the skills and characteristics necessary to successfully perpetuate the estate from one generation to the next. For example, a trust beneficiary (not a part of family leadership) has no financial proclivity; however, he is very interested in history. Family leadership may well wish to take advantage of the talent the beneficiary has by placing the responsibility of maintaining and expanding family records, history, genealogy, memorabilia and other family lore in his hands.

Absent inclusive governance, heirs are generally unaware of the contents of a will or the benefactor's objective for the estate up until the date of death. Then, suddenly, the heirs are expected to make the transition to full control and ownership. As so often is the case, the beneficiaries struggle to successfully perpetuate the benefactor's intent because the importance of the estate's governance was not made a priority during the benefactor's lifetime, preventing the proper tutelage of the succeeding generation. Whatever a family member's capability, leadership must find a way of employment.

At Probity, we propose that families separate control and ownership and begin the process of transferring control as soon as practicable. This can be accomplished by simply holding regular family meetings to review the Family Mission Statement, a topic covered in last quarter's newsletter. During the review, family leadership can assess family members for leadership roles and various other ways of involving heirs in the goals for the estate. Family leadership roles may include trusteeship in the family's trusts, officer positions in a family LLC, a general partner role in a family limited partnership, or even a director or board position in a family foundation or business. Whatever the level of contribution chosen for an heir, having a role in the management and disposition of family wealth is essential for each family member. Doing so passes the value of family capital to each heir without the accompanying hazards of actual ownership while placing the responsibility of the family's wealth in more capable hands.

An estate plan that combines a well thought out governance structure along with a system of trusts, business entities, or family foundations has tremendous advantages to outright ownership because of the protection, preservation and growth it provides. Every family is different, however, in its values, human capital, and other forms of wealth. As such, the specific legal structure that your family utilizes and the form of family governance established for the perpetuation of your family's wealth will be unique to your family. Undoubtedly, if you have an estate plan, you've likely considered the legal form of your estate. What you may not have spent much time considering, however, are some of the finer points related to ownership and control. If this is the case, call one of our planners and let us show you how control can be better than ownership.

By Buddy Ozanne



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www.WealthServicesAlliance.com

10000 N. Central Expressway Suite 1350
Dallas, TX 75231

214-891-8131 800-818-2663