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Managing A Concentrated Stock Position Wisely

The bear market was full of reminders of the perils of holding concentrated stock positions. In the financial sector alone, many former titans saw their share prices fall precipitously (and a few disappeared altogether). Though concentrated positions sometimes also provide extraordinary gains, a broad mix of investments holds a lower probability of loss. That doesn't mean you should immediately sell a concentrated stock position and replace it with a diversified portfolio—there are tax costs and other factors to weigh—but it does argue for managing them wisely.

Even if you discount the likelihood that a particular holding might lose most of its value, stocks' volatility could limit your investment gains. "The Hidden Cost of Holding a Concentrated Position[1]," a recent study by investment firm Robert W. Baird & Co., compares a hypothetical stock-and-bond portfolio to the 272 stocks that were in the Standard & Poor's 500 stock index from March 31, 1999 through March 31, 2009. The hypothetical portfolio, with 60% of assets in a broad mix of stocks and 40% in taxable bonds, outperformed most of the individual stocks, whose average volatility was four times that of the diversified holdings. (Volatility, often measured in terms of standard deviation, considers changes in the market price of an investment; the more sharply the price tends to rise and fall, the greater the stock's volatility.) And while 160 of the stocks failed to keep up with inflation—and 104 lost 20% or more—the hypothetical diversified portfolio produced a 45% gain for the decade, according to the Baird study.

One reason the diversified portfolio did so much better has to do with volatility's effect on compounded investment returns. The Baird study considers two hypothetical holdings that produced the same average annual returns during a two-year period but had very different levels of volatility. The first investment gained 50% the first year but lost 30% in year two, for an average gain of 10% and a volatility of 40%. The second investment gained 15% and 5%, respectively—also an average 10% gain but with volatility of just 5%. That makes a big difference in the performance of a $1 million investment in each holding. The first would jump in value to $1.5 million after one year before dropping back to $1.05 million after the second year, for compounded annual growth of 2.5%. The second investment, in contrast, would have been worth only $1.15 million after one year but $1,207,500 after two—a compounded growth rate of 9.9%.

So if diversification tends to provide reduced volatility, and that in turn may translate into better results, why would anyone hang on to a concentrated stock position? There may be many reasons, including legal restrictions on selling shares in an employer. But tax costs may be the biggest stumbling block. If you sell shares that have appreciated significantly

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In The Wake Of Financial Upheaval, Three Steps To Take

With nerves still frayed over the global economic crisis that began in late 2008 and more recent struggles in Europe, it's difficult to be optimistic. But it may be helpful to put the bad news about the American economy in perspective.

According to the International Monetary Fund, U.S. gross domestic product in 2009 totaled more than $14 trillion. That represented nearly a fifth of the world's total output of goods and services, even though we have less than one-twentieth of the world's population. America remains the world's dominant economic power.

And though much of the financial and economic news has been bleak, stock prices rose more than 70% from their March 2009 lows and the economy has slowly improved.

Where does all of this leave you? Here are three steps to take:

1. Be open to diversifying across asset classes that behave differently from each other, and to reevaluating your financial goals to ensure they are realistic.

2. Give more attention to your long-term financial plan—this is a time for proactive planning.

3. The recovery in stocks offers a chance to reassess your risk profile or to rebalance and sell some of your stock gains. If you learned during the market fallout that you can't tolerate as much investment risk as you thought you could, please call to make an appointment so we can consider changes to your portfolio.

Colleen & Rob

Retiree Relocation: Tax-Friendly States

Are you thinking about pulling up stakes when you retire? You may want to move to a state with warm temperatures and lots of sunshine, but there's also another kind of climate to consider—the tax climate. State taxes as well as federal levies can take a big bite out of retirement income, and some states devour decidedly more than others do. Here are several factors to take into account.

State income taxes. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—have no state income tax, and New Hampshire and Tennessee tax only investment dividend income that exceeds specified limits. However, many other states and the District of Columbia provide tax breaks for retirees, so you shouldn't automatically assume a no-tax state will be the best choice.

Retirement income. Most states that normally tax income provide partial exemptions for pensions. Even better, 10 states fully exempt income received from federal, state, or military pensions. And in Pennsylvania and Mississippi, all retirement income, including distributions from 401(k)s and IRAs, is state tax-free. Some other states impose high income tax rates on retirement income, however, with California leading the way at 9.55% on income of less than $1 million.

Social Security benefits. Up to 85% of the Social Security benefits you receive may be subject to federal income tax. However, the seven no-tax states, 27 others, and Washington, D.C. don't tax Social Security, though other special rules may apply. For instance, in Colorado, New Mexico, and Utah, you must add back a portion of Social Security benefits not taxed on a federal level when determining your eligibility for certain state income tax breaks.

Sales tax. These levies are often overlooked when retirees contemplate a move. On the plus side, five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—currently have no sales tax, and other states may exempt food, medicine, and other necessities. But California has an 8.25% rate, and many cities and counties pile on additional sales tax charges. In Chicago and Los Angeles, you'll pay a combined rate of 9.75%—the nation's highest. And things could get worse. In 2009, 649 U.S. cities imposed new sales taxes or increased existing rates, while only 192 reduced sales tax rates (Source: Vertex Inc.).

Property taxes. The property tax burden varies widely throughout the country and even within states. The five states with the lowest median property taxes are Louisiana, Alabama, West Virginia, Mississippi, and Arkansas, while New Jersey, New Hampshire, Connecticut, New York, and Rhode Island have the highest.

Of course, tax rates aren't likely to be your only reason for choosing a particular retirement location. But it can't hurt to factor in these very real costs when planning your move. ●

Ups And Downs Of Caregiver Agreements

In 2009, an estimated 66 million Americans provided more than $400 billion worth of unpaid care to elderly parents and other loved ones, according to AARP. As the economy continues to struggle and family budgets tighten, an increasing number of those caregivers are accepting pay for their efforts, most often from an aging parent.

There is a right way and a wrong way to do this, says Linda Fodrini-Johnson, a geriatric care consultant in the San Francisco Bay Area and president-elect of the National Association of Professional Geriatric Care Managers. The right way is to draw up a written caregiver agreement, a formal contract that makes it clear what a caregiver is expected to do, how much he or she will be paid, and other details of the relationship. A well-drafted agreement can help elderly parents remain in their homes while keeping family strife to a minimum, says Fodrini-Johnson. Meanwhile, the caregiver receives extra income and the parent's estate is reduced, minimizing potential estate taxes.

But not every contract will provide such benefits. "Consult an attorney to make sure this is a binding agreement that would hold up in court," suggests Fodrini-Johnson. "If it looks like you're trying to spend down assets or bypass legitimate taxes, you could be breaking the law."

Caregiver agreements cover what the caregiver is expected to do (from cooking and cleaning to helping the person dress and bathe), how much time it will take to do these tasks, the rate of pay, and how often payments will be made. If a family has multiple siblings, each of them should sign the agreement, especially if only one is providing the care. The caregiver is responsible for federal and state taxes due on the income, and the rate of pay must be in line with standard rates for similar work in the area.

Understanding The Realities Of Charity

For charities, the economic downturn has posed extraordinary challenges. Social services organizations, in particular, have faced mushrooming demand as unemployment, family problems, homelessness, and other human symptoms of the downturn all have increased sharply. At the same time, corporations, foundations, and individual donors, feeling the economic pinch, have cut back on their support.

According to the Giving USA Foundation, donations fell 3.6% in 2009 to $303.75 billion, down from $315 billion in 2008. This is the steepest decline in current dollar terms since Giving USA began its annual reports in 1956.

You may have been compelled to limit your own philanthropic contributions, and even if you've found a way to continue giving, it's more important than ever to make sure your dollars are having maximum impact. You need to know about the organizations you support—how they're using your money, how efficiently they're run, and whether they're living up to their missions.

In order to get a tax deduction for your gifts, you also need to have a proper acknowledgement from the charity and adhere to the IRS's recently toughened requirements. These are the new realities of charitable giving.

The internet has greatly simplified the process of finding a charity, learning about its mission, and doing due diligence before you contribute. Guidestar.org, for example, maintains a directory with information about almost two million charities recognized by the IRS. You can search the database for a particular organization or use keywords, location, and other criteria to look for groups with a specific mission. Type in "homeless" and click Arizona, for instance, and you'll get a list of 210 organizations.

Guidestar and other sites provide comprehensive information about a charity's activities. Charity Navigator (charitynavigator.org) evaluates the financial health of more than 5,400 of America's largest charities, while the Better Business Bureau (bbb.org/us/charity) offers a wealth of resources for both charities and consumers. Its "Wise Giving Guide" summarizes the results of recent evaluations of charitable organizations and provides tips on gift-giving and charitable accountability issues. The American Institute of Philanthropy operates a website (charitywatch.org) that grades more than 500 public charities and focuses on special issues such as compensation for charity executives, top-ranked groups, and "hot topics."

With all of this information literally at your fingertips, it's easy to dig deeper. Find out how much of a group's budget goes to its programs and how much is earmarked for fundraising, other administrative costs, and overhead. (Most organizations should allocate at least three-quarters of their spending to programs.) Look at a charity's annual reports to evaluate its finances and its commitment to its mission. Be wary of those that have consistently operated at a loss.

You can read more financial details in the Form 990 every charitable organization must file with the IRS. Look for a copy on the group's website or call to request one.

Most major charities have adopted a "Donor Bill of Rights" that several philanthropic associations jointly created. Available at Charity Navigator and other internet sites, the document lists 10 things you should expect from any reputable group. This includes information about the group's board, whether it uses paid solicitors to ask for donations, and a promise to treat donors with respect. These guidelines give you one more tool for taking stock of an organization you're considering.

Once you've selected a charity and made a donation, you need to make sure that you have the documentation needed to claim an income tax deduction. The Pension Protection Act of 2006 tightened the rules for substantiating monetary gifts, and you now must have a written record of any contribution. If the IRS asks, you need to be able to show a bank statement or a written communication from the charity verifying your gift. This should show the organization's name, the date of the contribution, and its amount. This requirement now applies to all monetary contributions, even small gifts given in cash.

Charities need your help now more than ever. If you understand the realities of charitable giving, you can deliver your money to deserving groups that will put your generosity to good use. ●

But no agreement, however carefully drafted, will succeed if the parties to it aren't comfortable with the caregiving arrangement, says Fodrini-Johnson, who points to several potential problems.

- Someone who provides care out of guilt or an inability to say no will most likely fail to provide adequate care.
- Similarly, a reluctant caregiver doing it only for the money probably won't be successful. "You have to really like people and love elders," she says. "Emotional abuse can happen if you're not happy to be there."
- A caregiver may begin to feel guilty about accepting money from a family member.
- Making this a paid relationship may change the tenor of the connection between parent and child.

We can help your family avoid these pitfalls by setting up a caregiver agreement that takes into account all of the complex financial and emotional aspects of your situation. And if you're in your 50s or 60s, purchasing long-term care insurance now could go a long way in helping to avoid this situation. Please give us a call if you'd like to discuss the possibilities. ●

Choosing An Estate Planning Attorney

A recent article in a financial trade magazine describes a case with an unlikely happy ending. A couple had engaged an attorney to help them with their estate planning. But their assets never got retitled in the name of the trust that the attorney created for them, rendering it meaningless. What made the case newsworthy was that the oversight, along with other planning deficiencies, were discovered—and corrected—when the couple later hired a financial advisor. Without those changes, the estate tax at the husband's death would have been hundreds of thousands of dollars higher, despite the attorney's faulty though well-compensated efforts.

The couple might well have stayed out of trouble if they'd chosen their attorney more carefully. Here are six crucial questions to ask at an initial meeting—and what to make of the answers.

Are you a specialist? Estate planning is an esoteric area of the law. You want a pro, not a dabbler. Ask what percentage of the attorney's time is spent on estate planning, and how long he or she has practiced in that specialty. Look for credentials such as certification in estate planning (in some states) or membership in professional organizations and societies, such as the American College of Trust and Estate Counsel, that provide continuing education and information on the latest developments.

Am I a typical client? You also want a lawyer whose cases are similar to yours in terms of estate size, the type of assets owned (such as a business or real estate), and estate-planning objectives (philanthropy, for example). Ask for a profile of the attorney's typical client as well as how many cases like yours the lawyer has handled.

What is the cost? Will you pay an hourly or fixed fee, or does your quote specify a range? Compare the cost with what others charge. Ponying up for the expertise of a top law firm could be smart if you have a very large, complicated estate, but more routine cases may be better served by a reasonably priced solo attorney.

How long will the process take? Ask how many meetings will be needed, what documents you'll receive, and when those will be ready for your signature. Again, knowing how other attorneys operate can help you evaluate the answer.

How will you work with my financial advisor? A coordinated effort between professionals produces the best outcome. Ask: "Will my advisor be invited to attend meetings? If not, can you discuss meeting results with my advisor? Will you copy my advisor on all correspondence and documents? Will there be other interactions between your office and my advisor?" Does the attorney talk about working as a team, and keeping everyone in the loop? Or do you sense an attitude of, "I just handle the legal work. Your advisor can call me with questions."

What services are included? As the fortunate couple's case demonstrates, legal documents are only as good as the implementation that follows. But not all lawyers provide the same level of follow-through. Be certain that your attorney is willing to work with your other professionals to handle everything outside his capacity. Also, find out who monitors the paperwork and the cost of this service. By clarifying responsibility at the outset, you won't need happenstance to produce a happy ending. ●

Managing Stock Wisely

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since you bought them, you could find yourself paying today's 15% tax on long-term capital gains on almost the entire proceeds (unless you have large capital losses from this year or a prior year to offset your gains)—and that knocks a large hole in a new, diversified portfolio.

There are several alternatives to selling all at once. You might offset some risks of further concentrating your position by avoiding that holding's company and industry in the rest of your portfolio. You could divest your shares gradually in order to stretch out your tax liability. Very wealthy investors may be able to put a portion of concentrated holdings into an exchange fund, which avoids immediate taxes and gives investors shares in a diversified portfolio. Using some of the stock position to fund charitable goals could provide tax advantages and income, and company insiders might use a preprogrammed selling program known as a 10b5-1 to unload restricted shares.

All of those possibilities involve complex planning issues and need to be considered in view of your overall financial goals. For example, the current capital gains tax rate is the lowest it has been in many decades and may rise soon, and that could make it advantageous to incur those taxes now, not later. We can work with you to assess the vulnerability of a concentrated stock position and help you manage it wisely. ●

Five Ways To Manage A Concentrated Stock Position

1. Avoid similar holdings in the rest of your portfolio
2. Divest your shares gradually to stretch tax liability
3. Fund charitable goals with part of your holding
4. Put a portion of the stock into an exchange fund
5. Use a 10b5-1 preprogrammed selling program

[1] The hypothetical stock portfolio in the Baird study had 12% of assets in large-cap growth, 14% in large-cap value, 8.5% and 3.5% in mid-cap and small-cap shares, respectively, 14% in international holdings, and 8% in a mix of "satellite" investments (emerging markets, high-yield bonds, commodities, and real estate).

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