Trusted Advisor

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Half Time Report

Clients have received their quarterly reports in record time this month. Thanks to the hard work of Ed McElroy, our technology consultant, we were pleased to mail most performance reports by July 3rd. More importantly, the reports carried good news for clients, most of who have been patient and who have honored the proven strategy of long - term investing and a consistent value approach. Consequently, our discretionary client accounts rose 9.08% for the second quarter and 7.67% for the first half of 2003.[1]

Index Investing: the Five-year Record

At the outset of an investment management relationship, I ask clients to ignore short-term market gyrations and to focus on a three to five year horizon when judging performance. This is good advice for any type of investing, even the self managed approach. If you are unhappy with your own investment choices after five years, fire yourself and get a better manager!

From the perspective of the most recent five-year horizon, ended June 30 2003, the self managed investment strategy of "indexing", promoted by business magazines that seek to advise do-it-yourselfer's, has been an abject failure. Even with a healthy rally in recent months, the ninety-one Standard & Poors Index mutual funds tracked by Barron's lost an average of 2.12% per year![2]. Even the most stubborn self-manager must by now realize that the expenses saved by investing in index funds has been a poor compensation for stomach churning activity that has resulted in nothing but capital erosion.

Intelligent investing requires diligent research, and a conscious effort to find superior businesses, trading at favorable prices. Sadly, most actively managed mutual funds fail to outperform the indexes. A few have distinguished themselves, especially by preserving capital through the storms of the turn of the century bear market. I am of the belief that my investment approach which combines the forces of my own analysis and the capabilities of some of the world's best mutual fund managers, is superior to indexing and well worth our management fee of 1.25% per year.

Is your home in your living trust?

I was surprised recently to discover that many wealthy Orange Countians may not have taken steps to reduce their potential estate tax by transferring ownership of their homes to an estate planning living trust.

Most of our clients have established a living trust to take fullest advantage of estate tax planning. This is usually a wise course of action. Under the current estate tax laws, when a spouse dies, the surviving spouse pays no estate tax on assets inherited from the deceased. Damage to the children's ultimate inheritance may occur, however, when the second spouse passes. If the couple's assets have been gathered under the name of the surviving spouse, and they total more than $1,000,000 [3] at the second demise, then anything passed to the kids above this amount will be taxed at the Federal death tax percentage rate of 41 % or more. That's a lot of wasted inheritance!

The purpose of a living trust arrangement is to allocate the couple's joint assets at the time of the first death so as to "double" the effect of the Uniform Estate and Gift Tax Credit. Instead of only utilizing $1,000,000 credit at the time of the second death, an additional $1,000,000 exemption is gained because of trust provisions that segregate deceased's assets into a "Children's" trust.[4] At the first death, these assets are declared on Federal Estate tax form 760 and if less than $1,000,000, the tax is entirely offset by the Uniform Credit. Free of any future estate tax, these funds remain in a trust account,

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generating income for the surviving spouse and reasonable access to the principal as well. If, over her /his remaining life, the survivor does not need to consume all the assets in this "Children's" trust, what's left eventually goes to the kids. Over the survivor's remaining years, the survivor's assets can be consumed at will. What remains of the survivor's assets at the second death is usually combined with assets already in the "Children's" trust, and another $1,000,000 Uniform Estate Tax Credit is applied against this second inheritance. Thus, a total shelter of up to $2,000,000 is applied to the couple's combined estate over the period of their joint lives. This Uniform Credit will rise steeply in the next few years, but may be considerably reduced after 2010, under current legislation, so it is probably a good idea to maintain life insurance policies that may offset future estate taxes.

With residential real estate values soaring here in Southern California, many middle class couples have an estate that is nearing or above the $2,000,000 figure, and may soon achieve this level if we continue to enjoy a better stock market. For most couples the single largest asset they hold is their home. Surprisingly few people, even those with estate trusts, have recorded their homes in the name of the trust with the County.[5] This can complicate asset-shifting strategies at the first death, and may lead to a bigger estate tax bite. A home owned in Joint Tenancy or Community Property can be transferred to a living trust by filing a new Grant Deed with the County. This type of filing does not trigger a property tax reassessment. You'll want to have your estate attorney review this strategy before acting.

How Risky are Bonds?

If you want to quickly find an asset class that has become riskier than it was at the beginning of the year, look at bonds and bond funds, some of which have declined in value with the sudden rise of interest rates. To understand the relationship of bond prices to interest rates, visualize a teeter-totter. On the left sits Ms. Interest Rate and on the right, Mr. Bond Price. As interest rates go up, bond prices go down, and of course the opposite is true as well. Generally, bonds with long "durations"(roughly equivalent to maturity date) are more sensitive to interest rate changes. Up until the second week of June, with interest rates scraping 45 year lows, bonds appreciated in value. Since that time the benchmark ten year Treasury bond has lost 8% in market value.[6] By contrast, one of our key bond holdings, Pimco Total Return fund is off only 2.8%. Having experienced sudden reverses of interest rates many times in the past, I've been wary of over exposure to this sector.

Generally we have shortened the maturities in client portfolios, eliminated long term zero coupon bonds, and chosen high dividend paying common and preferred stocks as bond substitutes. The above-mentioned Pimco Total Return fund has kept it's durations relatively short, and included TIPS (Treasury Inflation Protection Securities) in it's portfolio. As a result, the give back in client bond portfolios has been minimal. However, it is important to look beyond short term bond price fluctuations and recall that current income is to be treasured, and good quality bonds are a key source of real measurable cash flow. They will remain a core part of client portfolios.

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(Footnotes)

[1] These figures are not independently audited. A complete, detailed performance track record is available for inspection. Individual results may vary, please note the disclaimer at the end of this newsletter. These results slightly under performed Barron's "Balanced Funds" average year to date 2003, but the one year record is more satisfying. Our accounts rose 4.52% while the average Balanced fund rose 2.91% for the twelve months ended June 30 2003.

[2] Barron's On line July 7 2003

[3] Unified Estate tax credit is available to each person and equates to $1,000,000 per spouse in 2003, rising to $1,500,000 in 2004.

[4] This is also known as a "Credit Shelter" trust

[5] Results of an informal review of property titling in Southern Orange County, conducted by Gary E. Miller, July 2003.

[6] U.S. Treasury 3 5/8% of 5/15/13; Source: Bloomberg Professional

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