

**Personal investing**

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Milestone

# Trust Topics®



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**T**hey are typical of many investors, so let's call this couple Jane and John Doe.

Ten years ago, Jane and John started serious planning for their retirement. They told themselves that they wanted to retire with \$1 million in investable assets.

They were on track, closing in on their goal, when the recession began, and the financial markets tumbled, slashing the value of their savings. Undaunted, they continued to invest. They believed that the goal was still attainable, though it may take a few extra years of work to achieve.

However, now they have a new worry.

When Jane and John did their planning, they expected that \$1 million could be invested safely to provide an annual income of \$50,000, just 5%, which then was consistent with short-term Treasury yields. Adding a bit of risk, they hoped, might get them to a 6% or 7% return.

You know what happened. Yields on fixed-income investments have dropped sharply, especially those at the safest end of the spectrum. Today, \$1 million invested "risk free" might produce about \$15,000, scarcely a third of what Jane and John had hoped for. (See *Low returns for T-bills* on page 2 for details.)

## **Meeting the investment challenge**

Many of our new investment or living trust clients are investors who face the same challenge that confronts Jane and John. How can they invest their capital to generate more income without running unacceptable investment risks?



**Create a safety net.** The first step toward meeting that challenge, we believe, is setting aside an adequate reserve fund. Granted, today's short-term interest rates look puny by past standards. Nevertheless, it's wise to have sufficient cash reserves to meet six months' expenses — even a year, to be extra cautious. This reserve fund also

should include enough to meet any special family expenses — such as college tuition — expected within the next few years.

The point of the safety net isn't only to provide rescue when needed. It also gives one the confidence to take risks that otherwise might be unacceptable. The safety net also allows some remaining portion of the portfolio to be committed for a longer term, without the fear of premature sale.

**Diversify.** The second step is mapping out a diversified, long-term investment program for the balance of the investable assets. "Diversified" usually means putting money into stocks as well as bonds, and into international securities as well as domestic ones. Why? For at least three reasons:

**1.** Although the market values of both bonds and stocks fluctuate from day to day and year to year, the fluctuations do not always parallel each other. As a result, a long-term investor who owns good-quality stocks as well as investment-grade bonds may run less market risk overall than an investor who puts everything into bonds.

**2.** Interest income from a bond remains the same year

## Income investments

### Bonds and bond funds

**Treasury bonds** are sure to pay interest on time and sure to be redeemed on schedule. Interest is exempt from state and local (but not federal) income tax.

**Corporate bonds** of investment quality offer somewhat higher yields than Treasuries, and interest is fully taxable.

**High-yield bonds**, sometimes known as “junk bonds,” are lower-rated corporate issues. Because investors take on substantial added risk, interest yields must be more generous. Corporate bonds need to be monitored, as their status may change with the changing fortunes of their issuers. For decades, the bonds of Chrysler and General Motors were of investment quality, but at some moment, that changed.

**Tax-exempt bonds**, issued by municipalities, states and other local government entities, lately have offered higher yields than Treasuries, which is an anomaly. Usually, the exemption from federal tax results in a yield discount, which nonetheless means more spendable income to high-bracket taxpayers. Generally, interest from tax-exempt bonds is also free from state tax in the state where the bond was issued but is taxable in other states.

### Income stocks

**Out-of-favor stocks.** Dividends have come back into favor, after a period of unpopularity while investors looked for capital growth instead. Now, qualified dividends can receive the same favorable tax treatment as long-term gains. As stock prices fall, the dividend yield rises (provided, of course, that it continues to be paid).

### How to wring . . . continued

after year. Dividends from good income stocks tend to be lower to start with but can be expected to grow over the years, especially after an economic recovery takes hold. That's a major plus, especially when you consider the potential for inflation in our future.

3. U.S. stocks no longer dominate the world markets as they once did. Much of the world's future economic growth is expected to occur outside the U.S.

### What if income isn't enough?

One need not confine oneself to the shortest-term investments to build a measure of safety into a portfolio. A program of staggered maturities for bonds, for example, can add more income from the longer end of the yield curve. However, the longest maturities are accompanied by the risk of paper losses if long-term interest rates move upward, as would be expected during an economic recovery. As a rule, the more distant a bond's maturity date, the more severely its market value will fluctuate in response to changes in interest rates.

Dividend-paying stocks can be a productive way to generate income, rather than growth, from a portfolio. See *Income investments* on the left for more information.

Investors who need additional cash flow have no alternative but to dip into principal. There's a right way and a wrong way to do that.

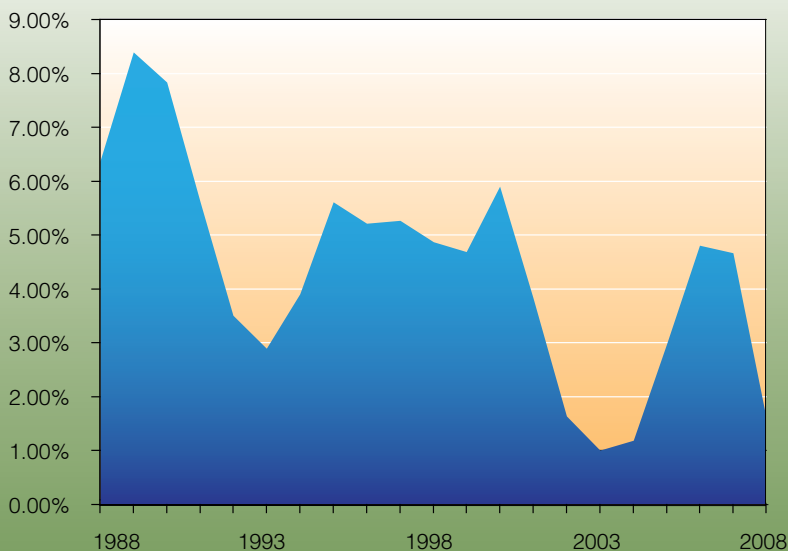
The wrong way is to risk money on shaky investments offering excessively high or remarkably regular yields — think Bernie Madoff. When these dubious ventures fail, investors may lose everything.

The right way is to stick to prudent investments, then supplement income with a planned program of limited capital withdrawals. For instance, one retiree looked up her life expectancy, doubled the number of years, and now has started a withdrawal program that won't exhaust her assets until the end of that period.

### Call on us

As a trust institution, we've provided prudent investment supervision for family funds from year to year and generation to generation. Our experience and insights are at your service. At your request, we'll be glad to meet with you in person and discuss your investment needs. □

Low returns for T-bills



Source: M.A.Co. Data: Ibbotson SBBi 2009 Classic Yearbook

# The burden of choice

## *More isn't always better*

In an experiment summarized by Gary Belsky and Thomas Gilovich in *Why Smart People Make Big Money Mistakes* (Simon & Schuster, 1999), shoppers in a grocery store were offered free samples of fancy jellies and a \$1.00 coupon good for buying a jar of their choice. During some hours, the samplers had six kinds of jelly from which to choose, and at other times, they were offered 24 different varieties. The coupons were bar-coded to enable tabulation of the buying response of the two groups. The results were somewhat surprising.

Increasing the number of choices to 24 led to a dramatic increase in traffic to the sample table, as 50% more shoppers tasted the jellies and accepted the coupon. However, with all those choices, many more people could not make up their minds. Of those who were exposed to only six choices, 30% used their coupon, to make purchases, but in the group presented with an array of 24 flavors, only 3% took the purchasing step.

Too many choices, it would seem, can lead to indecision.

## *The role of emotion*

Recently, a different sort of experiment about making choices was discussed during National Public Radio's *RadioLab*.

Two groups each were given a number to memorize. They were told that once they were confident of the number, they would proceed to another room and recite the number for a researcher. Participants in one group were given two-digit numbers, the others seven-digit numbers (like a telephone number without the area code).

As each participant walked to the second room for the recitation, he or she was interrupted and offered a choice of snack by another researcher. The choice was between a piece of chocolate cake and a cup of fruit salad.

By a statistically significant amount, those who were remembering two digits favored the fruit, and those with the longer strings of digits chose the cake.

The researchers assumed that because the fruit salad was healthier, it would be the rational choice, all things being equal. The cake, on the other hand, would be a less rational, more emotional, preference. The study concluded that when one is working with larger amounts of data — such as remembering seven digits instead of only two — one is more likely to rely upon emotions in decision-making.

## *An investor's context*

Whether research such as this has meaning for investors is a provocative question. For example, sponsors of 401(k) plans, accepting the implication that more choices may result in delays of investment decisions by plan participants, might respond with a cap on the number of investment alternatives for participants.



One can quarrel with the idea that chocolate cake is bad and, therefore, an emotional choice, while fruit salad is inherently a better and more rational choice. But the larger, clearer point is that the subjects who were under minor stress — the need to remember more numbers but with no penalty for failure — made different choices than those who had less stress.

It goes without saying that these are stressful times for investors, and that investors are deluged with more and more economic and investment data on a daily basis. That's why we believe that professional investment advice has become more valuable than ever.

To learn more about our capabilities in this area, please contact one of our investment officers at your earliest convenience. □



## A victory for entrepreneurs

Paul and Alicia Garnett owned interests in seven limited liability partnerships and two limited liability companies. All these entities were engaged in agribusiness — production of poultry, eggs and hogs. On their federal income tax returns for 2000, 2001 and 2002, the couple reported income and losses from these ventures on a consolidated basis. The IRS disallowed some of the losses, on the grounds that they were passive investments. Losses from passive investments are only deductible from the future profits, if any, from that same investment. The deficiency from 2000 alone was \$170,268, which triggered an additional tax penalty of \$34,054.

The couple took their case to the Tax Court, where they won an important victory. The IRS based its position on a tax law enacted in 1986 that limits the loss deductions associated with limited partnership interests. Temporary Regulations interpreting this law were announced in 1988 but were never finalized. Limited liability companies (LLCs) and limited liability partnerships (LLPs) are different from limited partnerships and were invented well after the law and regulations governing limited partnerships. Nevertheless, the IRS has argued that LLPs and LLCs are covered by those rules because they limit the liability of the investors, and that is the key determinant.

Not so, the Tax Court now has ruled. The more important factor is whether the investor materially participates in the operation of the business enterprise. The state statutes allowing for LLPs and LLCs do not bar such material participation as a condition of the limitation of liability. As the Court found material participation, the losses were allowable. Note that the losses could have been deducted against salary income as well.

Because this was a decision of the Tax Court, it applies nationwide. Owners of small businesses around the country soon may be getting calls from their accountants and financial advisors.

## Milestone

The federal deficit crossed the \$1 trillion mark for the first time in history in June, the Treasury Department announced on July 13. An average deficit spending rate of \$42,866 per second, around the clock, seven days a week, was needed to make this happen.

To put that into context:

- 1 million seconds is 11.57 days.
- 1 billion seconds is 31.68 years.
- 1 trillion seconds is 317 centuries. □



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