ASPIRIANT

Insight

Wealth Management Commentary
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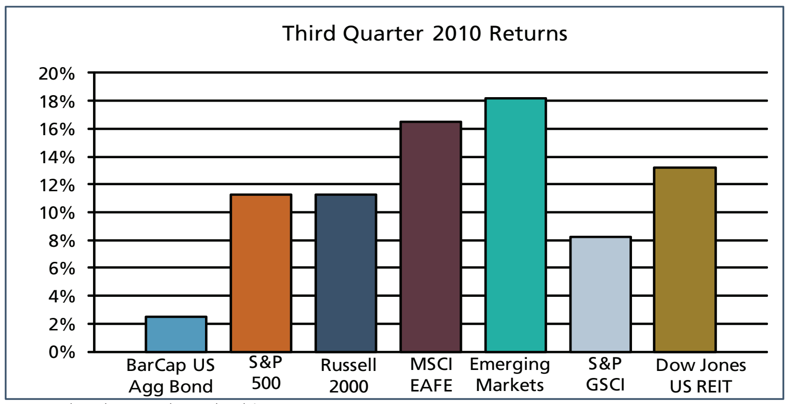
IN THIS ISSUE

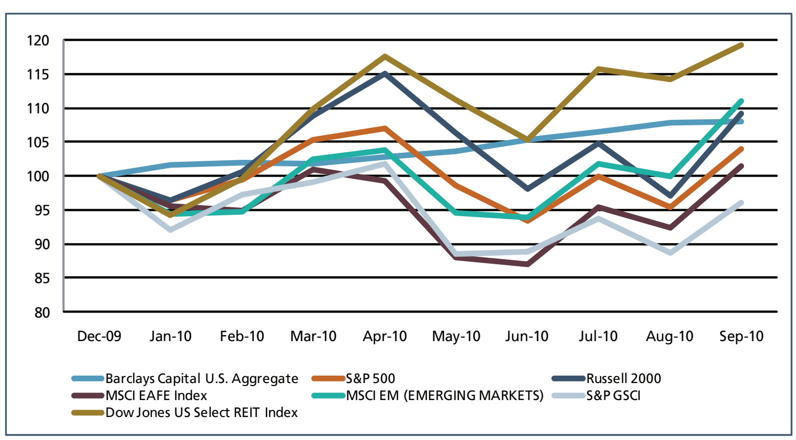
Third Quarter Recovery

As we had expected, the third quarter of 2010 showed significant continued volatility in investment markets but as we had hoped and believed likely, produced net positive results for all asset classes.



Source: Bloomberg; Zephyr StyleAdvisor

Overall, the quarter produced substantial gains in equity classes (the All Country World Index was up 14.46%) and the closing month of September was the strongest in many decades. As a result, performance for most client portfolios has recovered from negative at mid-year to very respectable positive numbers, year-to-date, as we move into the final quarter of 2010.



Source: Bloomberg; Zephyr StyleAdvisor

continued on page 2

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Still, from one month (week…day…hour) to the next, global investment markets respond to current news that shows actual growth in the world's economy, but with significant variation from one region to another and at an overall pace that remains weak. Most investment gauges are below their 2010 highs in late April and still far below the pre-crisis highs of late 2007.

Many market participants remain unconvinced that economic conditions warrant a commitment to riskier assets. From one day to the next, some not really wonderful news spurs positive market performance and some not such bad news produces market declines. No strong, clear conviction appears in evidence. Some commentators have likened investors' mood to suffering post traumatic stress disorder where modest reminders of pain cause disproportionate fear of a return to the disaster of late 2008 and early 2009. Those times were traumatic indeed and the stress they caused was very real and, for many, very severe. It may, realistically, take significant additional time and a period of sustained market performance for true healing to occur. We hope that, despite the frequently renewed pain, the results of this past quarter demonstrate that significant rewards for risk-taking do occur.

Meanwhile, virtually all of the factors we mentioned in *Insight* three months ago are still in play: a very poor job market, excessive sovereign debt, terrorist threats, lousy consumer sentiment, and tax and regulatory uncertainty, to name just a few on the negative side, and very low interest rates, low inflation, growing corporate profits, an apparent bottoming of the residential real estate market, modest equity valuation levels, and an immense pool of investable cash, on the positive side.

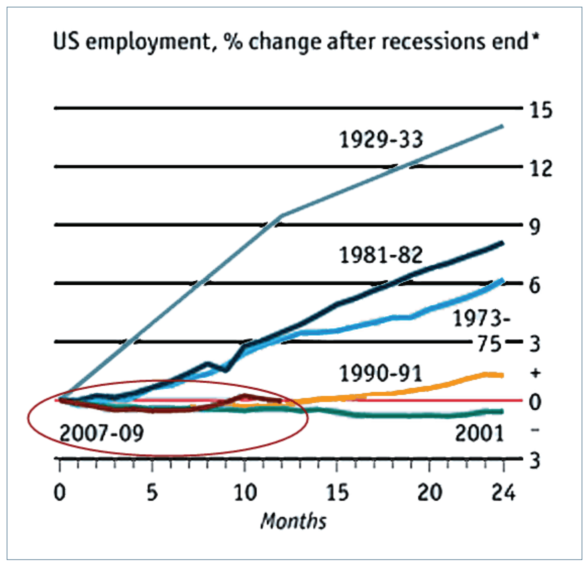
Where the balance will be struck, no one can be certain, especially in the near term. We suspect that it will take both significant recovery in employment statistics and sustained advances, even if modest, in housing prices to convince many US market participants. This optimism may already be well underway in many markets outside the US. We are convinced that long term and durable investment commitments to the full scale of global investment opportunities will very likely be well rewarded. Our job is to help you best participate in that expected reward at a level of risk that you can tolerate and that may be necessary to achieve your goals.

As always, we are eager to continue the dialogue about how you make that match between needs, desires, and opportunities and the resources available to fulfill them.

Tim Kochis
Editor

The Great Uncertainty

It is no wonder that symptoms of confidence in the US – from consumer sentiment to the flavor of political discourse – remain depressed despite the strong stock market performance this past quarter, especially in September: the U.S. economy is in unfamiliar territory. The "Great Recession" has been followed...so far...by the most shallow recovery in employment on record, measured in terms of absolute numbers of jobs. Hiring was weaker in the aftermath of the relatively mild downturns of 1990-91 and 2001, when the unemployment rate topped out at 7.8% and 6.3% respectively, but fewer jobs were lost. The Great Recession was much more severe, with a peak unemployment rate of 10.1% and more than eight million jobs lost. Slightly more Americans were working when the recession ended in the middle of 2009 than are working now, over a year later.



Source: Bureau of Labor Statistics; The Economist.
** Recessions defined by the NBER.*

Adding insult to injury, concern about the stumbling recovery in the US has been rising just as anxieties about the European economy have faded. Some economists believe the disappointing U.S. GDP growth of 1.7% in the second quarter (after 3.7% in the first quarter) could be the start of a slide towards a second recession and that the dollar is the weakling among developed markets currencies. In contrast, booming sales to fast-growing emerging markets drove the strongest German economic growth in decades in the second quarter and pushed unemployment down to 7.6%, a bit lower than at the start of the financial crisis.

Yet only a few months ago, the fortunes were reversed. The US seemed to be recovering strongly and Europe was the laggard. The dollar was riding high as investors fled the euro area's debt crisis and street protests against austerity measures in Greece turned violent.

This emotional rollercoaster is a symptom of the "great uncertainty" facing the global economy. Each day brings headlines which seem to justify the dominant mood (fear or greed) and each day the economic compass seems to point in a different direction. Here we present our attempt to look through the noise and focus attention on the critical opportunities and challenges of the next year.

Three Things Which Should NOT Keep You Awake at Night…

Inflation/higher interest rates. Inflation is not determined by random forces outside of the economy, but rather is largely determined by the supply of money relative to other goods. With tremendous spare capacity in the economy, demand-side inflation factors are mute; the balance is in favor of money – money's value is remaining strong, with little inflation in the prices of most goods and services.

> *What if we're wrong?* Because much of the inflation in the economy (other than supply-induced commodity price spikes) is the result of market expectations and long-term dynamics, unexpected inflation will likely appear only gradually. There are a number of scenarios (geopolitical events, natural disasters) which could cause commodity prices to spike, which could have a severe impact on global economic growth.
>
> *Portfolio implications.* We have maintained allocations to longer-duration bonds (especially municipal bonds) and have tilted our fixed income portfolios toward a "barbell" structure (more short- and long-duration, less intermediate), which we expect to outperform in a rising rate environment. We are prepared to further adjust durations of client portfolios or buy direct protection if we see inflation on the horizon. Our commodity allocation mitigates the impact of commodity price inflation.

Municipal bond risk. It is difficult to make sweeping generalizations about the "municipal" bond market. There are over 80,000 issuers with bonds guaranteed by state and local governments and individual project revenue. Much has been written about the difficult budget situations facing many municipalities, but we believe that media coverage has been a little one-sided. While issuers have faced revenue difficulties,

From the CEO

This quarter was exceptionally good for our clients' portfolios, with September enjoying some of the best monthly performance in US markets in many decades. We are ever grateful for the privilege our clients give us to assist them in strategizing and implementing their investment portfolios. This is a crucial part of our work in comprehensive planning for optimizing their overall financial circumstances. We are, of course, especially pleased when intelligent planning, wise perseverance, and careful implementation and management help to produce excellent investment results for them.

The end of this quarter witnessed a very important milestone for Aspiriant. On September 30, we completed the acquisition of the Deloitte Investment Advisory business. Now, as our subsidiary, **Aspiriant Investment Advisors** brings an additional 40 talented professionals to serve our clients and increases our overall size in clients and portfolio management responsibility by approximately 70%. But, this is about much more than size and the scale advantages that such an increase brings. It is about our ability to attract and reward the finest talent in our field. It makes our promise to clients of resourcefulness and durability even more credible.

I am also very happy to report that Nathan Wong, Investment Operations Specialist in our San Francisco office, has just achieved the very prestigious Chartered Financial Analyst (CFA) designation. Nate now joins the ranks of our 9 CFA's within the Aspiriant organization. Congratulations, Nate!

And, with great pride, I'm delighted to report that one of our founders and our former CEO, Tim Kochis, will be awarded the P. Kemp Fain Award by the Financial Planning Association at its convention in Denver this coming weekend. Tim is no stranger to illustrious awards and recognitions; and because of its long tenure, many consider the Kemp Fain Award to be the highest award in our profession. If it is, Tim deserves it. In any event, we're all refusing to think of it as a "lifetime achievement award". We're sure that Tim's achievements – on behalf of clients, our firm, and our profession – are far from over.

Rob Francais
Chief Executive Officer

states and municipalities are taking extreme measures to cut expenditures and are committed to servicing existing debt. Underfunded pension liabilities, while a serious long-term issue, do not create a near-term cash flow crisis.

What if we're wrong? The likely adverse scenarios involve a worsening in the financial position of municipalities and concern about their willingness and ability to pay rather than widespread default. We believe a number of factors would support municipal bond values: surprisingly light municipal bond issuance due to political gridlock and a bias toward less spending, the Build America Bond program, which encourages states and municipalities to issue taxable bonds further reducing the supply of municipals; and the prospect of rising tax rates, which increases the attractiveness of municipal bond income.

Portfolio implications. Short duration, high quality municipal bond yields remain at or near historical lows and appear to have little room for improvement to result in enhanced returns to bond portfolios. Investors, generally, are giving up a lot of return to reduce interest rate risk. In contrast, we are overweighting long-duration and lower-rated sectors.

A "new normal" with slow economic growth and low returns. Expectations for economic growth in developed economies are lower than they have been historically, but, as we've continued to say for many years, emerging markets have more opportunity for productivity growth and room for fiscal expansion (due to their lower leverage) and are likely to grow much faster. Innovation in telecommunications and business models are increasing productivity of knowledge workers, bringing more talent into the global labor pool (The World Is Flat, in Thomas Friedman's phrase), and more effectively addressing smaller markets. Successful innovation typically increases economic growth and eases inflationary pressure.

What if we're wrong? A period of slow growth, if accompanied by a reduction in uncertainty about the economic environment, might still lead to a period of better than expected returns on financial investments. However, confidence in the global economy and financial system is currently low, and a self-reinforcing cycle of contraction could take hold.

Portfolio implications. Aspiriant portfolios are well-diversified, with exposure to diverse streams of economic activity around the world. We are working hard to incorporate strategies which reduce volatility and protect against severe market downturns ("tail risk").

…And Three Things Which MIGHT

Disruption in the global financial system. One of the most important elements in any financial system is confidence. The events of the past two years and the government response around the world have shaken confidence. The impact of new regulations and policies remains to be seen and the most fundamental dangers (under-capitalized banks, shadow banking system, under-regulated derivatives markets) have not been aggressively addressed.

What if we're wrong? A healthy financial system is essential to continued economic growth. If the financial system regains confidence more quickly than we expect, returns on financial assets will likely skyrocket (mirrored by a precipitous decline in the price of gold).

Portfolio implications. Financial market stress would likely cause very severe losses in corporate credit holdings. We recently reduced our weighting to investment grade corporate debt, feeling that credit spreads were too low to justify continuing the overweight we added in early 2010. Our commodity positions have a modest allocation to precious metals, which provide some protection against financial market disruption.

Depletion of natural resources. Demographers expect the world population to peak in 2050 at 10 billion people, just after a period of rapid economic growth in the most populous countries. There is a lot we don't know about resource extraction and depletion. We expect economic forces to bring resource use and exploration into alignment over the long run, but if resource depletion happens quickly or governments introduce distortions (e.g., U.S. ethanol policy), the impact on the global economy could be profound.

What if we're wrong? An excess supply of natural resources would put downward pressure on commodity prices, benefitting both industrial and individual consumers. Plentiful resources would be supportive of economic growth and reduce the power of petro-dictators.

Portfolio implications. Aspiriant portfolios have protection against commodity price inflation in the form of commodity futures. We think of these positions primarily as a hedge against unexpected developments. It's far too early to plan extensively for the era after 2050 when the world's population is expected to begin to decline, but one can guess than there could be truly transformative changes if resource scarcity is even more pronounced…

Continued Tax Uncertainty, Too

Ordinarily, at this time of the year, we take this opportunity to alert clients to a variety of year-end planning considerations and offer general recommendations for opportunities we believe are compelling. Earlier this year, we were reasonably confident that, whether one would like the specifics or not, we would have clarity about income tax and estate and gift taxes going into 2011 and beyond. Due to the current political landscape, however, we now do not *expect* any important resolution, if any, until after the election on November 2 and the reconvening of the current Congress following that...but Congress may fail to take action even then. In any event, we find it next to impossible to confidently predict those tax outcomes at this time.

Since whatever resolution may occur will be critical to decisions clients may need to make before the end of the year (on issues such as deferred compensation elections, timing of option exercises or asset sales, the nature and timing of family wealth transfers, to name just some of the big issues), we now plan to send a special report to clients as soon as the fog of uncertainty begins to clear. Expect something, in whatever detail we can fathom, (which could be not much) before the end of November. Meanwhile, for a preview of what we may conclude if income tax rates do increase for 2011, you can review our comments from the January 2008 edition of *Insight*.

Among the biggest open questions for many of our clients will involve the next steps on the Roth IRA conversions we helped them make earlier this year. For almost all such clients, we do not expect that "recharacterization" will be attractive and, for many of them, paying the entirety of the resulting income tax as a 2010 item may continue to be the overall best timing choice. This environment of Roth conversions has presented an opportunity to demonstrate our objectivity and alignment with the best long-term interests of our clients. Paying the full tax burden at once, and paying it early will probably foster the greatest value for the conversion for many clients. And even where paying in deferred installments (2011 and 2012) is the better choice for some others, those very substantial near term tax payments will reduce the assets we manage and thus, the base on which our fees are calculated. In the long-run, of course, we will benefit from the enhanced value these Roth conversions will produce for our clients. But, in the short-term, we, along with our clients, are making a significant investment in that better future.

or if, because of a then declining population, the world shifts from an economics of scarcity to an economics of abundance. Only some of us will live long enough to see how this will play out.

<u>Geopolitical conflict and terrorism.</u> There are complicated dynamics in the world economy, with some leaders manipulating domestic and international issues to their advantage. Populations and ideologies which are unhappy with the status quo are gaining in power and size. Religious and ideological conflict and competition over global political influence and natural resources could engender armed conflict or at least undermine cooperation.

What if we're wrong? Increased global harmony would likely lead to improved trade policies and regulatory stability – a "peace dividend" which would be very welcome, indeed.

Portfolio implications. Geopolitical tension most frequently shows up in commodity prices, exchange rates, and interest rates. Aspiriant portfolios have extensive global diversification as well as protection against commodity price inflation in the form of commodity futures.

These topics are not meant to be exhaustive or to offer a final word on these enormously complicated issues. Instead, they are intended to provide some insight into the thinking of the Aspiriant investment research team and to serve as a preview of the discussion around our current work in reviewing our long range capital market expectations and the modifications to portfolio mixes that could emerge from that work.

Jason Thomas, Ph.D., CFA
Chief Investment Officer

Transitioning from One House to the Next in the Post Financial Crisis World

Over the course of the last year we've assisted many clients as they move from one dream house to the next. In many cases, the transition hasn't been as smooth and easy as it was before 2008 when obtaining a mortgage was like buying a shirt, and it only took a month or two to sell a home in many real estate markets across the country. For those readers who are contemplating buying and/or selling personal residences in the near future, here are some themes we've recently addressed that may be helpful. Of course, your Aspiriant client service team stands ready to help you work through the details, and develop a strategy that is customized to your personal situation.

Buy first, sell later?

In a perfect world you'd sell one house before buying the next. This would free up equity in the former home, allowing you to know exactly how much cash from the old house you could use toward the purchase of the new house, and it would avoid debt service and maintenance requirements on multiple properties. In reality, that sequence of events, while usually financially less risky, can be harrowing for families. It typically involves having to move from the old house into temporary quarters (a short-term rental, a family member's home), and then, eventually, into the new house. In our experience, most clients identify and decide to buy the new house before selling the existing home. Of course, there are risks with this strategy.

How am I going to pay for the new home?

Deciding to purchase a new home always requires a plan for paying for it. Having a "soon-to-be-former" residence in the picture adds a new variable for consideration.

The starting point for developing the strategy is determining if a mortgage will be part of the longer-term picture. If so, in the current very low interest rate environment, we'll often recommend that the client borrow the maximum amount that the bank will lend, and the client's resources will be able to service, up to and even beyond the $1.1M maximum level qualifying for the mortgage interest tax deduction. If additional, *durable* debt is optimal for the client after considering the pros/cons of liquidating other (typically investment) assets, an even bigger mortgage could be appropriate if the property value supports it.

If there's a short-term need for additional resources to bridge the purchase of the new house until cash is available from the sale of the old house, we'll consider additional mortgage borrowing by way of the primary mortgage and/or by putting a home equity line of credit on the property if it's available, reasonably priced compared to other sources of short-term debt, and not subject to prepayment penalties. In many situations, temporarily borrowing on margin against the client's investment portfolio is a more convenient, less expensive debt source as long as the investment portfolio is big enough to cover the need without putting the account at risk of a margin call if investment markets suffer short-term downward volatility.

Once we've figured out the optimal debt strategy we'll look to the clients' cash reserves and, if necessary, will develop a plan with the client for selling other assets to raise the remaining money needed to complete the home purchase.

Is it still easy to get a mortgage?

Working with a bank, directly or through a mortgage broker, to secure a mortgage continues to be the most common way to secure mortgage financing. That said, getting a mortgage today isn't as easy and straightforward as in the years leading up to 2009.

First, many mortgage brokers and banks are overwhelmed with a surge in mortgage refinancing in response to low mortgage rates, and are dealing with new lending rules that slow down the process. In some cases we've advised clients to pay a slightly higher rate for a loan if working with the more expensive bank/broker means that there's a higher likelihood of closing the loan on time without hassle.

Second, the credit crisis coupled with FNMA underwriting guidelines has caused many lenders to place more emphasis on income-to-payment ratios in their loan underwriting process. As a result, even people with very large balance sheets but fairly low income are having significant difficulty securing loans. Aspiriant clients have generally been able to avoid this result because of our longstanding relationships with private client banks which usually remain comfortable lending based on the client's balance sheet and profile.

As far as mortgage products are concerned, we have advised clients for many years, and continue to advise clients to consider adjustable rate loans or loans with relatively short fixed interest rate periods instead of long-term fixed rate mortgage products. We expect clients to benefit from taking the interest rate risk over a full interest rate cycle instead of paying a bank to take the risk. See the article from second quarter 2005 at: http://www.aspiriant.com/library/insight/05q2/article05_pg01.html for more on this topic.

Can Mom and Dad be "the bank"?

Today's low interest rate environment offers a fantastic opportunity for family members with excess wealth to help children, grandchildren, siblings, etc. with home purchases.

Each month the government establishes minimum interest rates that must be charged on loans between related parties that are made during the month to avoid tripping on gift tax issues. These "AFR" rates are based on the term of the loan:

	Loan Term	AFR Rates for October 2010
Short-term AFR	Less than 3 years	0.41%
Mid-term AFR	3 – 9 years	1.73%
Long-term AFR	More than 9 years	3.32%

Like a mortgage, related party loans can be interest-only or amortizing. If they're secured to the house and the borrower hasn't already exceeded the $1.1M deductible mortgage balance limit, the interest will be deductible by the borrower (the family member lender recognizes the interest income on his/her/their tax returns). Additionally, the family member lender could decide to use the annual gift tax exemption (currently $13k/person/year) to forgive some or all of the interest and/or principal on the mortgage, thereby transferring value to the borrower without triggering gift tax. The title company (or attorney if you live in a non-escrow state) can help draft and secure the related party loan, usually for a minimal fee, during escrow.

I bought the new house…what if I can't sell the "old" house?

There have been several instances this year where clients have not been able to sell existing home as quickly as they had expected. This can be frustrating, and expensive! Four common ways of dealing with this situation are:

1. Grin and bear it. Continuing to own the vacant (or staged) home until it sells is the best course of action for some clients. In some situations, the house was listed at what turned out to be an inopportune time, and letting it remain on the market…or pulling it off until the next popular buying season comes along, may be the best way to optimize the asset. That said, this involves taking the risk that the market doesn't improve anytime soon...or, even falls...while continuing to bear all the costs of ownership.
2. Reduce the price to sell. Some clients can afford to sell the former house at what feels like a low price in order to unload the property, get out from underneath the maintenance costs, and move on.
3. Temporarily rent the house. Renting the house while you hold out for a higher sales price may be a good way to reduce/offset the carrying costs. It's also a convenient way to avoid holding an empty house, especially if you've moved away from the neighborhood. Of course, this strategy involves you becoming the landlord responsible for making fixes that need to occur…or paying to outsource the role to someone else. It also exposes you to the risk that the tenants don't take good care of the house, and there's the possibility that the rental period is prolonged because the housing market takes even longer than expected to turn around.
4. Some combination of the above.

Your client service team, with input from your real estate agent, can help you evaluate the best course of action for you based on your objectives and your available resources.

What else do I need to think about?

It's important to title real estate in a manner that is consistent with your estate plan, pre-nuptial agreement, or other legal structures you have in place. If you own the property jointly with someone other than your spouse, make sure that you are observing arrangements you have with that person to ensure "clean" transactions; for example if you own a house 75%/25% with your brother and your arrangement is to split costs in that manner, make sure you're paying (only) 75% of the expenses.

Another important consideration is making sure that your homeowner's and umbrella insurance policies are current and cover both homes until you sell the old house. If you decide to rent the former residence before selling it, make sure the homeowner's policy for that home reflects the rental situation.

Sandi Bragar
Director – Wealth Management