ASPIRIANT

Insight

Wealth Management Commentary

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Sailing Through the Storm

"I'm not afraid of storms, for I'm learning how to sail my ship."

- Louisa May Alcott

Executive Summary

- Recent volatility in equity markets is being caused by global equity markets adjusting expectations for lower economic growth and an increased risk of recession, primarily due to disappointing growth in the US and the ongoing European debt crisis.
- The macro economy remains resilient. While we don't expect a return to recession, economic growth will likely continue to ebb and flow as economies work off the overhangs from the housing bubble.
- Increased volatility is normal during an economic recovery as equity markets attempt to anticipate future growth and respond to often conflicting information. Equity investors should expect substantial volatility for the foreseeable future, but not at the level exhibited in recent weeks.
- While as investors we cannot control volatility, we can control our reaction to it. When the urge to do something strikes, long-range planning puts the current investment environment into the appropriate long-term perspective.

Just when you thought it was getting safe to go back in the water, another storm has engulfed the global financial markets. As with all financial crises, this one is marked with grim milestones: US sovereign debt downgraded for the first time in history; our elected officials flirt with a catastrophic default; and Europe's largest economies appear increasingly shaky, causing concern that the Euro-zone might split apart.

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Last Year's Headlines

"*Europe Crisis Deepens as Chaos Grips Greece*" Sebastian Moffett and Alkman Granitsas. Wall Street Journal, May 6, 2010

"*Fearful Investors Are Pulling Out*" Adam Shell. USA Today, May 20, 2010

"*Housing Prices Remain Weak*" Sara Murray. Wall Street Journal, May 26, 2010

"*Fear Returns—How to Avoid a Double-Dip Recession*" Cover story. Economist, May 29, 2010

"*Spill Tops Valdez Disaster—Deep Trouble: There Was 'Nobody in Charge'*" J. Weisman, G. Chazan and S. Power. Wall Street Journal, May 28, 2010

"*Discouraging Job Growth Batters Stocks*" Don Lee. Los Angeles Times, June 5, 2010

"*Economic Outlook Darkens*" Jonathan Cheng and Justin Lahart. Wall Street Journal, June 2, 2010

"*Bond Fund Managers See Signs of a Bubble*" Sam Mamudi. Wall Street Journal, June 8, 2010

"*Rapid Declines Rattle Even Optimists*" E.S. Browning. Wall Street Journal, June 14, 2010

This Year's Headlines

"*Greek Woes Fuel Fresh Fears*" Marcus Walker and Hannah Benjamin. Wall Street Journal, May 10, 2011

"*Fear Wins: Stocks Resume Long Slide*" Adam Shell. USA Today, June 16, 2011

"*Home Market Takes a Tumble*" Nick Timiraos and Dawn Wotapka. Wall Street Journal, May 9, 2011

"*The World Economy—Sticky Patch or Meltdown?*" Cover story. Economist, June 18, 2011

"*Japanese Nuclear Crisis Is Ranked at the Level of Chernobyl*" Mitsuru Obe. Wall Street Journal, April 12, 2011

"*Jobs Data Stoke US Recovery Fears*" Robin Harding, S. Bond and M. Mackenzie. Financial Times, June 4, 2011

"*Stocks Plunge Amid Fears That Global Economy is Slowing*" Christina Hauser. New York Times, June 11, 2011

"*Why Are Investors Still Lining Up for Bonds?*" Jeff Sommer. New York Times, May 29, 2011

"*Investors Shaken by the Fear Factor*" James Mackintosh. Financial Times, June 18, 2011

Headlines assembled by Wellington, Weston of Dimensional Fund Advisors. *"The Best of Times, the Worst of Times"*, Down to the Wire, June 23, 2011.

When has it ever been so bad? Pretty recently, as it turns out. One doesn't have to look back very far to see headlines like today's. The sidebar compares headlines from mid-2010 with those we've seen recently.

Despite the scary headlines in mid-2010, global equity markets surged in the following year, several indices by more than 30%. Economic headlines are a poor indicator of future stock performance. Experienced investors cannot help but be appropriately humble about their ability to predict future events and how markets will respond to them.

Where is the economy headed?

The downgrade by Standard & Poor's of US long-term debt was widely expected and, while contributing to some fear-based selling, doesn't seem to have had any direct near-term impact on interest rates or the economy, for now. A "systemic risk event," such as the collapse of Lehman Brothers in 2008, appears unlikely, as do materially higher interest rates on Treasuries for now. (That could change if US policy-makers fail to adequately address long-term structural deficits, possibly resulting in further downgrades.)

For now, the market's main concerns seem to be the slow-motion debt crisis unfolding in Europe and slowing economic growth, particularly in the developed market economies.

US economic growth has slowed considerably from the pace of late 2010, and equity markets responded negatively in recent weeks as data showed that growth had slowed even more dramatically than expected. The concern, of course, is that the economy might be falling back into recession. In a "typical" recession, policymakers would apply a range of fiscal (increased government spending) and monetary (reduced interest rates) tools to boost growth. However, fiscal stimulus is politically unfeasible and the Federal Reserve has few monetary options remaining, boosting the risk of recession.

Still, there are reasons to be hopeful. The Federal Reserve has announced it will maintain the current, very easy monetary policy for at least the next two years. Corporations are very profitable and flush with cash, and the financial sector is in much better shape than in 2008. Productivity growth is slowing, possibly a sign that companies have squeezed as much out of their current employees as possible and will need to hire again soon. Slowing growth has also led to a recent decline in commodity prices, contributing to a reduction in the price of gas and putting more money into consumers' pockets. All of these factors support growth.

In our view, the debt situation in Europe is a more serious concern. There is the potential for contagion to the major European economies and banks. While European leaders haven't inspired confidence thus far by embracing a holistic solution to the crisis, the European Central Bank recently began outright purchases of Italian and Spanish government bonds, which halted the negative spiral. Negotiations within the Eurozone leadership continue.

Overall, we believe that the global economy remains resilient, and that the recovery will continue to unfold. However, the recovery is likely to continue to ebb and flow for some time to come as the economy works through some considerable headwinds, primarily the debt, housing and employment issues left in the wake of the burst housing bubble and subsequent recession.

Longer term, deleveraging among consumers and fiscal restraint in Western economies will likely weigh on growth, but over time should result in more sustainable levels of debt that support healthy economic growth.

Amid this backdrop, Aspiriant has updated our long-range capital market expectations, which guide our investment portfolio recommendations and long-range financial planning models. In two articles, Aspiriant's Chief Investment Officer, Dr. Jason Thomas, summarizes our 20-year global economic outlook and delves into one of the key growth-drivers going forward — developing markets.

What might lie ahead for equity markets?

While the current economic challenges are serious, we don't see the current environment as being fundamentally that different from the dynamic that we saw last summer. Then, after 14 months of nearly unabated growth in equity values, equities plunged 17% as the market realized that the hoped-for "V-shaped" recovery would not occur. This current period of adjustment is an entirely normal dynamic for financial markets emerging from recession.

Markets much prefer clarity and show their distaste for conflicting information with an increase in volatility. Consistent with our view of an uneven recovery, we expect equity market volatility will continue, though not at the current level as the path becomes clearer and the market finds a new equilibrium. It's important to remember that even when the markets begin marching upward again in anticipation of further recovery, that upward march will be punctuated by occasional periods of severe stress such as we've seen in recent weeks.

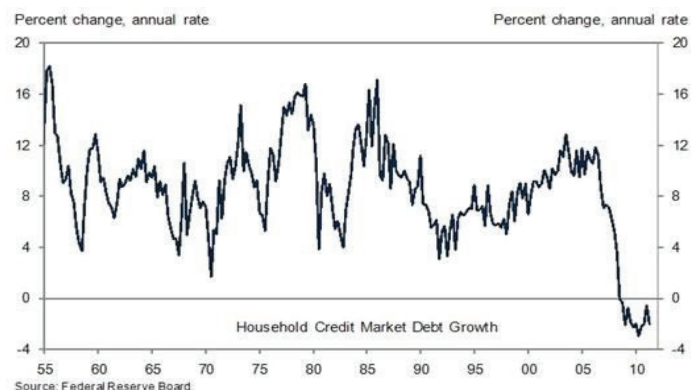
Being a successful long-term investor requires perseverance, restraint and optimism. The market severely tests all three qualities from time-to-time. We also find that context is critical to making wise investment decisions. Most clients, when faced with the occasional steep losses that the markets deliver, find solace in revisiting their long-range plans. Going through this exercise satisfies the craving to do something, highlights those decisions you can control, and puts investment choices into long-term perspective. And, happily, the exercise usually reassures clients that, despite passing investment losses, they can chart a very acceptable course forward. Your Aspiriant team is eager to give you this clarity and help you navigate these stormy seas.

Greg Schick, CFP®
Director - Wealth Management, Principal

Economic Headwinds: De-leveraging & Inflation

The Federal Reserve's Flow of Funds report for the first quarter shows continued deleveraging in the US economy. The broadest measure of debt owed by the nonfinancial (i.e., non-bank) sectors — which includes the borrowings of private households, nonfinancial businesses, and all levels of government — grew just 2.3% (annualized) in the first quarter. This was the third-slowest pace since the series began in 1952; only the second half (Q3 and Q4) of 2009 was lower.

One key reason for the weak growth in debt was the continued paydown of household debt. In the first quarter, nominal household liabilities declined by 2.0% (annualized), the twelfth consecutive quarter of debt paydown, as shown in the second chart below. This has taken the ratio of household debt to disposable income down to 114%, from a peak of 130% in 2007.



Source: Federal Reserve Board.

The implications of the ongoing deleveraging process for the economy are double-edged. On the one hand, it partly explains the weakness of US economic activity in 2011 so far. The US private sector is still running a financial surplus of 6.3% of GDP, which means that the level of spending remains unusually far below the level of income. At a time when real income growth has been restrained by the sharp increase in energy prices, this has depressed the growth pace of spending.

On the other hand, the deleveraging suggests that households have continued to repair their balance sheets and are thereby increasing their ability to spend in the future. The Federal Reserve Board publishes quarterly data for the household debt service burden, defined as interest payments plus scheduled principal repayments as a share of disposable income. Although figures for the second quarter are not available, the first quarter of 2011 showed a drop in the debt service burden to 11.5%, the lowest since 1995 and down from a peak of 14% in 2007. The debt service burden includes household debt service payments and financial obligations as a percentage of disposable personal income, seasonally adjusted.

The decline in the debt service burden is translating into an improvement in household credit quality. According to the New York Federal Reserve, newly delinquent loans to households in the first quarter fell to $250 billion or 2.2% of total household debt outstanding, down from a peak of $405 billion or 3.3% of total household debt outstanding in the fourth quarter of 2008. In turn, improved credit quality is translating into a greater willingness of banks to make loans to consumers. The Federal Reserve's quarterly Senior Loan Officers' survey showed that the net share of banks indicating greater willingness to make consumer installment loans rose to 28.8% in the second quarter, the highest reading since 1994.

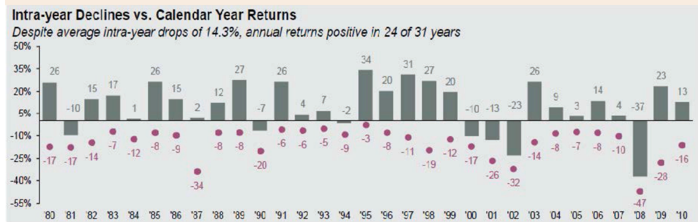
Over time, these improvements should feed into a pickup in household spending growth. Eventually, households will find that they have cut their debt stock sufficiently. At that point, spending should increase relative to household income. In turn, this should feed into stronger aggregate demand for goods and services, as well as positive multiplier effects in the labor market that again feed back into stronger income growth. The recent data suggest that this is a slow process, but we continue to believe that it will ultimately result in a stronger US economy.

In the context of weak economic growth, the significant acceleration of headline and core CPI inflation over the past year has been surprising. The surge in headline inflation

From the CEO

No matter how many times investors persevere through volatility in the financial markets, it never gets easier and always seems different (this time). Indeed, over the past 110 years, the S&P 500 has been in a state of correction, recession or bear market 46.2% of the time! That equates to almost 51 years of investor discomfort over the last 110 years. Investors have been rewarded for accepting this discomfort with attractive equity investment returns—nearly 9.8%, on average, for the S&P 500 each year since 1927.

What's more, markets are prone to suffer sharp intra-year drops even amid very good calendar year returns. Since 1980, the average intra-year drop has been a whopping 14.3%, yet the annual returns over this same period were positive in twenty-four out of thirty-one calendar years.



Source: Standard & Poor's, FactSet, JP Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops over periods of 6 months or less. Data are as of 6/30/11. Indices are unmanaged and have no fees. An investment may not be made directly in an index. Past performance is not necessarily indicative of future performance. All investments may lose value over time.

Clearly, the forces of economic activity that drive the financial results supporting the markets — things such as population growth, productivity, innovation, etc. — are far less volatile, so it stands to reason that there are much more volatile forces at play. One such force is human emotion.

"We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist; and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance."

—John Maynard Keynes (1964)

Because markets are merely collections of people who act according to their fears and desires of the moment, they are susceptible to the same emotional cycles and crowd influences that are observed in human nature. This, combined with an (ever increasing) instantaneous

and continuous connection between the investor's emotion and the financial markets, is likely one of the reasons for our having recently experienced one of the most volatile weeks in the history of financial markets. No matter what the reason, these forces are making it increasingly challenging to maintain the proper context and perspective that leads to good decision making.

At Aspiriant, we are committed to helping families see their way through these stressful times and stay focused on achieving their goals. During the last downturn, we learned from clients that they value more frequent communication that helps to put current events into better perspective (even in situations where we don't yet have all the answers). In response to this feedback, we have been actively reaching out to clients and we have supplemented those discussions with three special communications in the last month. We hope these efforts have been responsive to your needs.

While uncomfortable, this environment has also produced opportunities for clients to, among other things, take advantage of lower interest rates, employ more aggressive wealth transfer techniques, strategically rebalance portfolios efficiently, and harvest tax losses that can be used to offset future gains in less tax-efficient asset classes. Maintaining a focus on these opportunities is equally important to enhancing client investment strategies and we will continue to identify new ways to "make lemonade out of lemons" on your behalf.

In the meantime, in this issue of *Insight*, we will provide you with additional perspectives on the global economy, review our new capital market expectations, and outline some charitable giving opportunities that may be applicable to you.

With our genuine gratitude for the opportunity to serve you, we thank you for your partnership.

Sincerely,

Rob Francais, CPA
Chief Executive Officer, Principal

(which includes food and energy) has been driven primarily by gasoline prices, which have eased somewhat in recent weeks. Even assuming a move to higher oil prices over the coming year, the rate of increase in both commodity prices and the headline CPI should decline.

The pickup in core inflation (still below the Federal Reserve's implicit target of roughly 2% inflation) has two main causes. First, rental housing and vehicle prices have normalized after a period of outright deflation during the crisis; we expect modest positive rates of inflation going forward but do not see major warning signs of a sustained acceleration. Second, rising commodity prices have passed through into a few components of core inflation. This pass-through effect should fade if indeed commodity price inflation moderates and inflation expectations stay anchored.

For core inflation to move significantly higher would probably require fundamental capacity pressures, which are still some ways off in most sectors of the US economy. While areas like manufacturing do appear to be reasonably close to equilibrium capacity, others like services and the broader housing market are clearly not. Most importantly, the labor market remains extremely soft, suggesting wage growth will not be a source of significant inflation for quite some time.

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

The Next 20 Years – Our Updated Capital Market Expectations

Executive Summary

- The global capital markets are constantly evolving, which requires regularly updating forecasts of economic activity and long-term investment returns and volatility.
- We believe three forces will dominate the evolution of the global economy over the next 20 years — the migration of the global population to cities, converging standards of living between the developed and developing world, and rapid technological development. All of these are likely to drive robust economic growth, particularly in emerging markets.
- The biggest challenges to the global economy over the next 20 years will be political, not economic.

The recent turmoil in European debt markets and the debt ceiling circus in Washington reminded us all that the global capital markets are dynamic, reflecting the constant evolution of economies and the companies and people that operate in them.

Consequently, rather than taking a static approach to investment management, Aspiriant regularly re-evaluates the environment looking for opportunities for your benefit. As part of this process, we establish long-term (20 year) capital market expectations (CMEs) and re-evaluate them at least every two years. The purpose of the CME process is to:

1. **Ensure** that Aspiriant portfolios reflect the constantly-evolving global capital markets;
2. **Provide** portfolio expected returns to be used as one of the many inputs in our wealth planning process; and
3. **Guide** our portfolio construction and investment manager evaluation process.

The process of developing CMEs is intended to be biennial, to balance the desire to adjust portfolios in response to current events against the need for stable long-term forecasts. However, the tectonic changes in the global economy argue for a more in-depth analysis at regular intervals. Therefore, we conduct a comprehensive analysis of the global economy every six years.

More frequently, we combine our own research with views from international governmental and non-governmental organizations, academia, and investment managers to develop the short-term view of the markets that may be reliably helpful to our clients when implemented through tactical strategies. We publish our near-term expectations in our semi-annual Market Viewpoint.[1]

Current events influence our CMEs through long-term consequences. Some events which might be very important over the short-run may influence our current allocations, but may not be a factor in our long-run expectations. For example, near term interest rate movements are reflected in our current fixed income implementation but not in our expectation of long-term interest rate movements. Other events might have a significant enough impact on the structure of markets that they change our long-term return or risk expectation for an entire asset class, e.g., the dislocation in the municipal bond market in late 2008.

The Future Global Economy — Much Bigger, But Different

The vast majority of returns from investing are ultimately provided by the economic activities of firms and entrepreneurs. While we expect the future to be bright for the global economy, we expect the future global economy to be much different from the economy of the 1990s and 2000s. The primary goal of this year's project to develop capital market expectations and portfolio mixes is therefore to evaluate the global economy prospectively, looking for quantitative and qualitative signals about the future investment returns which it will generate.

While there are cross currents which will provide both head- and tail-winds to the economy over the next 20 years, we believe that three economic forces will dominate the evolution of the global economy:

1. The migration of the global population to cities, making them more productive and easier to reach with products and services;
2. The convergence[2] of emerging markets, as producers and consumers, to standards in the developed world; and
3. Technological change, which is increasing the productivity of companies in developed and emerging markets.

The Impact of Emerging Markets

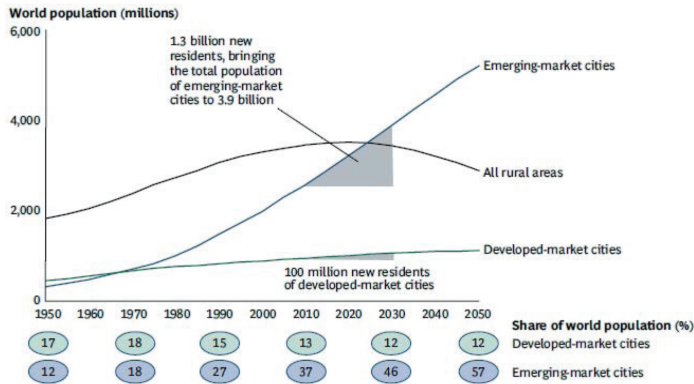
According to a recent study by Boston Consulting Group[3], one-third of the world's population (about 2.6 billion people) live in cities located in countries classified as emerging markets. By 2030, this number is projected to grow by another 1.3 billion. This population shift will fundamentally change the global economic landscape — consumer demand will increase rapidly as these workers use more productive technology (and therefore generate more economic value). As local companies compete with global corporations to meet the needs of the new middle class, the local companies will have an advantage. While it is the megacities (metropolitan areas with total populations in excess of 10 million people) that are often highlighted in the media, they account for just a fraction of the opportunity since a disproportionate amount of the growth is occurring in cities with fewer than 5 million residents. Local companies in these smaller cities that are positioned to serve these consumers will have tremendous opportunities to grow.

1 Our most recent Market Viewpoint, published in March 2011, is available at http://www.aspiriant.com/wp-content/uploads/2011/01/ Market-Viewpoint-201103.pdf

2 Economic growth theory predicts that a country with a lower stock of productive capital (machines, technology) than the rest of the world will grow more rapidly during the period of capital deepening. This "catch-up" is referred to as "convergence."

3 BCG (2010).

Rapid Growth Will Further Boost the Population of Emerging Market Cities



Source: BCG (2010) based on analysis of United Nations, World Urbanization Prospects: The 2009 Revision; Economist Intelligence Unit; Chan, K.W. "Fundamentals of China's Urbanization and Policy," China Review 10:1, 2010; Mitra, Arup and Mayumi Murayama, "Rural to Urban Migration: A District Level Analysis for India," IDE Discussion Paper No. 137, 2008.

By adopting technology, processes and policies of the developed economies, emerging markets have been able to grow faster, for longer, than any civilizations in human history. In particular, the introduction of mobile phone and internet technology has allowed economic growth to reach a very large portion of the global population without the fixed costs associated with prior shifts in modes of production.[4] The rise of the global middle class, which in China alone is expected to number over 500 million by 2017[5], has been made possible by the introduction of modern capital equipment and technology which enables labor to become more productive. And yet the largest and fastest growing emerging countries (China, India, Brazil) remain far behind on almost every metric of economic and social development.

While these changes have the potential to improve the lives of all, there will be pockets of the global population who suffer, at least on a relative basis, as their skills become less valuable or they are forced to compete with a larger pool of available labor. The losses from competitive change tend to be more concentrated than the gains, leading to protectionism and political strife. It is our belief that the biggest challenges over the next 20 years will be political, not economic.

An article elsewhere in this *Insight* delves further into emerging markets and their impact on the global economy.

The Developed Market

There are legitimate concerns about the developed economies' ability to grow in the aftermath of the financial crisis. With debt levels soaring, some market analysts have forecasted a "new normal" economy of lower growth rates and investment returns. This view, at least with respect to economic growth, is supported by the academic research which suggests that growth in the OECD countries will be weighed down over the coming decade[6].

But the result for returns to companies listed on stock exchanges in developed markets is less clear. The last 20 years has seen a deepening of the capital markets in developed economies, providing more access to economic growth. The market capitalization of the top stock exchanges in the US[7] rose from about 60% of GDP in 1990 to 185% in 2000 and is currently about 130%. The huge increase in market capitalization relative to GDP reflects a number of changes – public companies making up a greater percentage of economic activity, earnings growth, access to opportunities in emerging markets, and an increase in average P/E ratios. But it is clear that past relationships between, say, economic growth and local equity market returns must be reconsidered.

Asset Classes

Asset classes are groups of investments with similar risk-return characteristics, resulting from their similar relationship to economic activity.

The Relationship Between Asset Classes and the Business Cycle

RECESSION Low output Slow growth	RECOVERY Low output Fast growth	EXPANSION High output Fast growth	RECESSION High output Slow growth
Bonds Opportunistic	Real estate Public equity Private equity	Real estate Public equity PE/Opp Commodities	Bonds Commodities
Interest rates falling	*Interest rates rising*	*Interest rates rising*	*Interest rates falling*
Real Estate Public equity Private equity Commodities	Bonds Opportunistic Commodities	Bonds	Public equity Opportunistic Private equity

Source: Aspiriant. In each column, asset classes in the top box are expected to outperform asset classes in the bottom box. For illustrative purposes only. Past performance is not indicative of future results. All investments can lose value.

This can result in somewhat different definitions than are found at other investment management firms or research organizations. For example, the set of investments sometimes called "natural resources" may be spread across each of Aspiriant's five core asset classes:

4 By comparison, the industrial revolution which started in Britain in the mid 18th century took over 50 years to be felt broadly.
5 OECD (2010)
6 Reinhart and Rogoff (2010) estimate that the relationship between government debt and real GDP growth is weak for debt levels below 90% of GDP. But, above this threshold, median growth rates fall by 1% and average growth falls considerably more.
7 Includes the NYSE, the American, and the Nasdaq exchanges

- Debt or equity of publicly-traded commodity producers (fixed income or global public equity);
- Oil and gas pipelines (real estate);
- Debt or equity of privately-held commodity producing assets (private equity);
- Strategies attempting to profit from the dynamics of futures markets over time (opportunistic); and
- Ownership of commodities themselves (commodities).

Here we present a brief summary of our qualitative views about Aspiriant's five primary asset classes.

Asset Class	Outlook	Impact versus previous (2009) CMEs
Fixed income	The savings glut in emerging economies, combined with a lack of investment opportunity, will suppress global interest rates.	↓
Real estate	The incredible global migration from rural areas to cities will drive prices higher and provide opportunities for development.	↑
Public equity	Strong GDP and income growth in emerging markets will support rapid growth in corporate profits.	↑
Private equity /Opportunistic	The capital markets in developing economies are not as deep as in more developed economies; consequently, many of the best investment opportunities will be available only to private investors.	↑
Commodities	The high GDP growth rates enjoyed by China and other emerging markets, which are generally inefficient users of commodities, is associated with the emergence of a "super cycle" in commodities.	↑

Implementation in client portfolios

In response to changes in our CMEs, we made adjustments to our strategic (long-term) client portfolios. Our goal is to create baskets of exposure to economic activity which provides the highest expected return for any level of expected portfolio volatility.

The "efficient frontier"

For individual clients, we connect the efficient frontier to our deep wealth planning work to form a recommendation for each client's strategic allocation. The strategic allocation takes into account the magnitude and priority of clients' financial goals, their ability to withstand volatility in their portfolio value, and idiosyncratic circumstances (e.g., large real estate investments or concentrated holdings of public stocks). We implement the strategic allocation on a discretionary basis, choosing investment managers, establishing trading and rebalancing procedures, and making small tactical changes over time. Your client service team will work with you in the coming months to review the themes underlying our new capital market expectations, review the expectations with you, and apply them to your specific investment portfolio.

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

Coming Soon: Roth IRA Re-characterization Deadline

As we've reported in previous editions of *Insight*, clients who converted their traditional IRAs to Roth IRAs in 2010 have the opportunity to unwind the conversions (a process known as "re-characterization") before the final 2010 tax filing deadline on October 17, 2011 (extended because the 15th is a Saturday).

Clients would generally choose to unwind the Roth conversion only if the market value of the Roth IRA has declined significantly since the date of conversion. As of the writing of this *Insight*, most clients' Roth IRA accounts have experienced solid gains since the 2010 conversions; consequently, barring a sharp decline in equity values between now and October, it's unlikely that clients will choose to re-characterize their Roth conversions. Your client service team will reach out to you in the coming months to reconfirm this conclusion.

After the deadline passes and the opportunity for re-characterization is behind us, we will be able to consolidate accounts for clients with multiple Roth accounts from 2010 and earlier.

You can read more about Roth IRA re-characterization in last quarter's *Insight*.

Kacy Gott, CFP®
Chief Planning Officer, Principal

Wealth Transfer 101: Charitable Giving with Appreciated Assets

Executive Summary

- Making charitable gifts with appreciated assets (such as stocks or mutual funds) provides two substantial tax benefits — an immediate income tax charitable deduction and avoiding recognition of capital gain taxes on the sale of the asset.
- Donor-advised funds and private foundations create the opportunity to match the timing of the charitable deduction with the highest income years, when the deduction is most valuable, while "pre-funding" planned charitable giving for many future years.

Clients engage in philanthropy for many reasons, including:

- the opportunity to support causes about which they are passionate,
- giving back to the community,
- as a means of connecting with family and transmitting shared family values through generations, and
- to obtain the prestige and social benefits that come with philanthropy.

Life Outside the Office

Several Aspiriant employees have achieved some important personal milestones in the last few months:

- Jane Zaloudek, one of our owners in San Francisco, received an Honorary Doctorate of Humane Letters from Augustana College and gave the 2011 commencement address.
- Vanessa Justice, in our San Francisco office, married Vincent Reeder on May 20th.
- Jane Lee, in our Los Angeles office, married Ashley Wong on May 28th.
- Michele Phalen, in our Milwaukee office, married Eric Melton on June 26th.
- Gary Cosby, in our Cincinnati office, married Marilyn Kurelis on July 22nd.
- Lani Kapur, in our San Francisco office, married Freedom Rains on July 30th.

Congratulations Jane, Vanessa, Jane, Michele, Gary and Lani, from your friends and colleagues at Aspiriant!

Beyond the personal gratification of charitable giving, there are tax-related motivations that make it even more attractive. Charitable gifts create a valuable income tax deduction and reduce a client's estate for estate tax purposes; moreover, by giving appreciated assets (usually stock or mutual funds) instead of cash, clients can avoid the capital gains tax that otherwise would have been paid if the property was sold. Happily, after two years of strong gains in equity markets, clients' investment portfolios have large unrealized capital gains, creating a good opportunity to use appreciated securities for charitable gifts.

Of course, giving appreciated assets is not as convenient as simply giving cash or writing a check, and "checkbook giving" is the best approach for most small charitable gifts; however, for larger gifts (over $1,000), the benefit of using appreciated assets for gifts becomes more substantial.

Options for using appreciated assets

The most common ways to use appreciated assets for charitable giving include transferring appreciated assets directly to a charity or indirectly through a donor-advised fund (DAF) or a private foundation.

Direct gifts, in which a stock or mutual fund is transferred directly from a client's brokerage account to a charity's brokerage account, is simple, inexpensive and is often the best approach when the desire to immediately benefit the charity and the need for a large tax deduction coincide. But what about situations where these two facts don't coincide? In those cases, a charitable entity usually makes sense.

A donor-advised fund or private foundation are good alternatives for clients who want to receive a tax deduction in the current year but have not yet identified the charities they would like to support. Clients can give a large gift to the DAF or private foundation, claim an immediate tax deduction for the full amount of the gift, sell the securities and invest the proceeds tax-free in the entity, and then distribute gifts to charities over many years. This allows clients to match the timing of the charitable deduction with the highest income years, when the deduction is most valuable, and "pre-fund" their planned charitable giving for many future years.

While DAFs and private foundations are similar in some respects, there are important differences between them. DAF's are a flexible, cost-effective, low maintenance option for charitable giving. However, DAF's are sponsored by a public charity (e.g., a community foundation), and the sponsor is not legally obligated to follow gift requests (although they normally do). DAFs are ideal for someone who expects to

make most of their gifts to other public charities but are less appropriate for more targeted giving, for example, if a client wants to sponsor a scholarship for specific children.

A private foundation is often a better approach for clients who want more control over their charitable donations and the foundation's investment portfolio, or who want to actively involve other family members in their philanthropy.

As an independent entity, though, a private foundation is more expensive and time-consuming to administer; consequently, we recommend that clients establish private foundations only when they expect to make gifts totaling $2-3 million or more and distribute them over many years (often multiple generations).

Figuring the tax deduction

The amount of the charitable gift income tax deduction depends upon the type of property being donated as well as the type of charity receiving the contribution. Gifts to public charities (including DAFs), as opposed to private foundations, are generally treated more favorably for income tax purposes.

The maximum deduction for cash gifts to public charities and donor-advised funds is 50% of the donor's adjusted gross income (AGI), versus 30% of AGI for cash gifts to private foundations. The maximum deduction for gifts of long-term capital gain property (e.g., stocks or mutual funds held for more than one year) to public charities is limited to 30% of AGI, versus 20% of AGI for gifts of appreciated assets to private foundations. Happily, the deduction for gifts exceeding these thresholds is not lost; rather, any unused deduction carries forward for five years following the year of the donation.

The deduction for gifts of short-term capital gain property is limited to cost basis, so one generally wouldn't use highly-appreciated short-term property for charitable gifts. Gifts of real estate, artwork and other non-publicly-traded assets to private foundations have special (and generally less favorable) deduction rules, with the deduction often being limited to the client's tax basis in the property.

These rules are summarized in the chart below.

Character of Contributed Assets				
Type of Charity	Cash	Ordinary income property	Short-term capital gain property	Long-term capital gain property
Public Charity (or DAF)	50% of AGI	50% of AGI*	50% of AGI*	30% of AGI**
Private Foundation	30% of AGI	30% of AGI*	30% of AGI*	20% of AGI***

* Deduction limited to donor's cost basis ** Deduction based on fair market value of asset
***Deduction generally limited to donor's cost basis; exception for qualified appreciated securities (based on FMV)

By way of example, assume Jason Smith owns 100 shares of Google he purchased at $250 per share 3 years ago, and the current value is $500 per share. If Jason sells all 100 shares, he will pay $5,750 in capital gains tax ($25,000 x 23% combined state and federal rate). If Jason instead contributes the shares to charity, he will avoid paying $5,750 of capital gains tax and will receive a $50,000 charitable tax deduction, saving him $21,500 of tax ($50,000 x 43% combined state and federal rate). Thus, Jason can effectively contribute $50,000 to charity with a net cost of just $22,750.

Charitable giving with appreciated assets: A case study

It's not unusual for clients to have a combination of high employment income, highly-appreciated securities, and substantial charitable intent. This creates a situation where, with a little planning, clients can obtain very significant tax benefits.

Mary Smith is an executive at ABC Co., a large public company. She is 55 and expects to retire by year-end. For years she has actively supported a number of organizations, including her alma mater, her children's school, and several other charities, giving about $50,000 per year. She wants to continue to give at this level throughout her retirement. Post retirement, Mary plans to take some time off and then become involved in working with several of her favorite charities.

Mary has accumulated $2 million of ABC stock over the years, most of it before ABC went public, so her cost basis in the stock is just pennies per share. She also has substantial ABC stock option holdings, which will generate $5 million of income when she exercises them at retirement later this year.

The confluence of events — Mary's very high 2011 income, highly-appreciated ABC stock, and ongoing charitable intent — creates a great opportunity for strategic charitable giving. Mary establishes a donor-advised fund in 2011 and donates $1 million of ABC stock, where it is sold tax-free and diversified. In doing this, Mary has created a pool of charitable assets that will indefinitely fund her $50,000 of annual giving. By making the gift with appreciated ABC stock, she avoids paying over $200,000 of capital gain taxes. She also receives a $1 million tax deduction in 2011; her high income allows her to deduct all of it in 2011 (when her tax rate is at the highest level), saving over $400,000 of income taxes.

So, Mary has made a $1 million gift that "cost" her less than $400,000! While this exact fact pattern doesn't come along all that often, many Aspiriant clients can apply these principles and obtain a similar outcome.

No matter how or when you choose to make charitable gifts, funding your gifts with appreciated securities improves the cost effectiveness of your giving. Your team can help you determine how to best apply these principles to your own situation.

Kelly Cruz, JD
Manager - Strategic Planning

Emerging Markets … Emerging.

Executive Summary

- The developing world has driven global economic growth over the last decade, and we expect that this shift in economic leadership will continue.
- Emerging economies' growth is refocusing on other emerging markets and their own growing consumer basees, which will help sustain rapid growth rates even as developed countries experience weak growth.
- If we are wrong about the strong economic growth and capital market returns we predict over the next 20 years, we believe the most likely causes will be resource constraints or geopolitical conflict.
- We can (and should) use the same methods of analysis on emerging markets investments as we do in the rest of the portfolio.

Over the past decade, a group of emerging and developing economies have shifted the world's economic center of gravity — global growth in gross domestic product (GDP) in the last ten years owes more to the developing world than to the advanced economies. The implications of shifting wealth for the global economic and social landscape are only starting to be understood, but it is clear that issues which primarily affect developed markets (for example, the indebted US consumer) are not the entire (or even the primary) story.

Emerging markets and the global economy

An additional 1.5 billion workers joined the global economy in the 1990s[1]. These workers became productive very quickly — in China, the percentage of the population living in poverty fell from 60% in 1990 to 16% in 2005. The number of poor people worldwide declined by 120 million in the 1990s and by nearly 300 million in the first half of the 2000s. The magnitude of these changes dwarfed the marginal changes in the developed economies.

It is widely known (and decried in the US) that there has been a massive shift in manufacturing capacity from Organization for Economic Cooperation and Development (OECD) members to the developing world, particularly to East Asia. But shifts are also evident in the distribution of technological capacity, reflected in the rising amount of R&D being carried out in the developing world both by developed market multinationals and by local companies. Many of these local R&D teams are focused on a new business model involving "frugal innovation" — designing products and production processes to meet the needs of the poorest consumers. These innovations are increasing the effective market size by an order of magnitude relative to the typical developed market innovations, which is reflected in the trade between these developing countries.

What We're Reading Now

Looking for a good read? Here are a few suggestions from the bright minds of Aspiriant. Enjoy and Happy Reading!

I recently read *A Bitter-Sweet Season (Caring for Our Aging Parents – and Ourselves)* by Jane Gross. A writer for the New York Times describes her experience caring for an aging parent and the challenges with siblings, the medical system, health insurance, etc. It is full of information and ideas. It's a tremendous guide to anyone navigating this unfamiliar, psychologically demanding and profoundly emotional territory.

– Mike Fitzhugh

[Editor's note: for a recent article on making life better for older adults, please see last quarter's piece by Brett Gookin: *Making Life Better For Older Adults*

I'm currently reading *The Big Roads* by Earl Swift, which charts the creation of the US interstate system. From the turn-of-the-century car racing entrepreneur who spurred the citizen-led "Good Roads" movement, to the handful of driven engineers who conceived of the interstates and how they would work—years before President Eisenhower knew the plans existed—to the protests that erupted across the nation when highways reached the cities and found people unwilling to be uprooted in the name of progress, Swift follows a winding, fascinating route through twentieth-century American life.

– Mary Ellen Krueger

I recently read Laura Hillenbrand's *Unbroken: A World War II Story of Survival* – Wow! This story is about survival when you can't imagine even wanting to go on. A bomber is shot down over the Pacific during WWII and the main character, who prior to the war was an Olympic runner, survives with one other airman. He somehow manages to stay alive in the middle of the Pacific for weeks (I won't reveal just how many, since that's part of what makes this story so amazing), only to end up in a series of POW camps where the treatment was horrific to say the least. Through it all, he manages to retain his dignity and honor and, ultimately, finds a path to forgiveness and redemption.

– Cammie Doder

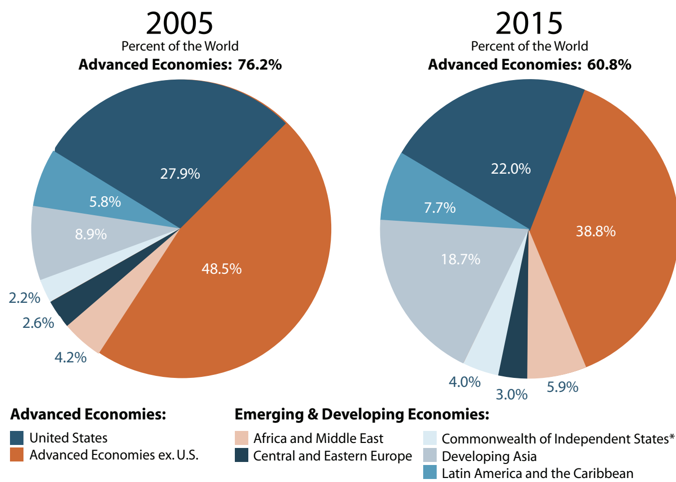
1 OECD (2010).
2 Grimwade (2000).

After World War II, international trade was predominantly among high-income countries, particularly Europe, the United States and Japan[2]. But over the last two decades that picture has changed significantly. In 2008, trade between developed market economies accounted for 41% ($6.5 trillion) of the world total, down from 58% in 1990. Developing countries were responsible for 23% of global exports in 1990 ($0.82 trillion) and 37% ($6.2 trillion) in 2008. Within this total, exports from developing countries to other developing countries increased from 7.8% to 19% of global trade.

The above suggests that the continued growth of consumption in developed markets may not be a limiting factor to growth of emerging economies. Despite expectations for weak growth in developed markets, the World Bank expects good growth in emerging markets as these countries shift from being dependent on exports to developed nations to refocusing on other emerging markets and their own growing consumer base.

World Economies at a Glance

Share of GDP (in USD)



Expected 5 Year Compound Annual Growth Rate

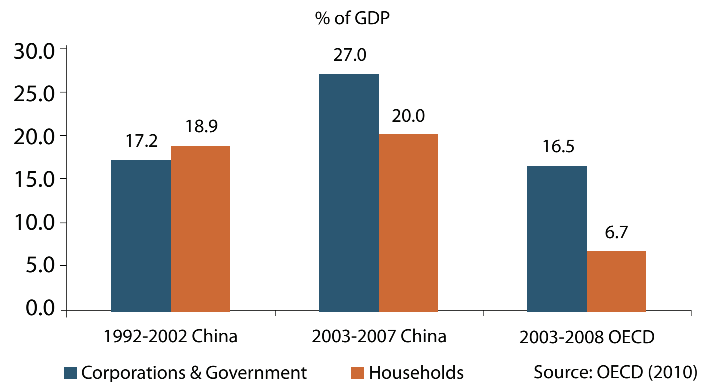
World	**5.8%**
Advanced economies	**3.9%**
United States	4.3%
Advanced ex-US	3.7%
Emerging economies	**9.1%**
Africa and ME	8.1%
Cent/East Europe	7.0%
Commonwealth of Ind St	10.9%
Developing Asia	11.0%
Latin American and Carribean	6.0%

Data: Year-end GDP in USD; 2015 is an estimate. Due to rounding, share numbers may not equal 100%. Source: International Monetary Fund; Crandall, Pierce.

Impact on the global capital markets

It is beyond the scope of this article to discuss the many implications of the rise of emerging markets for the global capital markets. But one has direct consequences for Aspiriant's long-range capital market expectations that drive clients' investment portfolios — the rise of foreign reserves in large developing economies, particularly China. China has seen a strong rise in retained corporate earnings, surpluses of government-owned enterprises, and personal savings in recent years[3]. By earning and saving wealth from the global economy, the Chinese are running a significant current account surplus with other countries like the US. Much of these savings are invested in global bond markets, driving down interest rates. This "savings glut" produced very unusual US yield curve behavior in 2005-2006, with intermediate-term rates remaining stubbornly low despite increasing short-term rates driven by the Federal Reserve.

Savings Balances in China and OECD Countries



The array of socio-structural explanations for China's saving surplus suggests that monetary tools and exchange rate management alone will be insufficient to restore balance to the global capital markets — we believe the savings glut is here to stay. This is incorporated into our capital market expectations, which reflects a long period of below average bond returns.

Elsewhere in this *Insight*, we present an overview of the other impacts we expect to arise from the rapid development of emerging markets, including returns for public equity, real estate and private equity/opportunistic strategies which are much higher than we've experienced over the last 10 years, though in some cases lower than the long-term averages.

3 OECD (2010).

What if we're wrong?

The improved economic performance of emerging countries raises the question of whether we are truly in the early stages of an extended period of growth across the developing world or, instead, if we are merely in the kind of cyclical upturn that we have seen in the past.

There is a long tradition of economists and economic historians trying to identify the point of "take off" into sustainable growth.[4] We believe that it is different this time because of a number of factors at play in the large emerging markets:

- Sound macroeconomic policies;
- Pro-business orientation;
- Build up of significant foreign exchange reserves;
- Movement up the value chain and diversification away from natural resources and labor-intensive industries; and
- A viable domestic consumer market, in part due to urbanization.

If we are wrong about the strong economic growth and capital market returns we predict in emerging markets over the next 20 years, we believe the most likely causes will be resource constraints (including pollution and the disposal of waste) or geopolitical conflict.

Gaining perspective

Investors tend to be in two camps with respect to evaluating investments in emerging markets:

1. Emerging markets groupies who believe the growth story of emerging markets, particularly relative to developed markets, makes emerging markets a can't lose opportunity; or
2. Emerging markets xenophobes who believe emerging markets are foreign, lawless places offering volatile investments which are best avoided or minimized.

Of course, neither of these represents the appropriate perspective. Though they may have different opportunities and challenges, emerging markets must play by the same rules of economic gravity as all countries. Therefore, we can (and should) use the same methods of analysis on emerging markets investments as we do in the rest of the portfolio.

We look forward to sharing our analysis and perspective with you over the coming months.

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

Wealth Transfer 301: The Family Charitable Remainder Trust

Executive Summary

- For clients with large and highly-appreciated stock holdings, the FCRT provides an opportunity to diversify the position, defer the associated tax liability and pass substantial wealth to successive generations.
- The complexity of the FCRT makes it most appropriate for clients who are likely to have taxable estates (over $10 million, under current law).

After successive years of strong gains in equity markets, many clients' investment portfolios have large unrealized capital gains. For the charitably inclined, an outright gift of these appreciated securities to charity produces great income tax results (see article on the benefits of using appreciated assets to fund philanthropic goals), but what if you want to pass your wealth primarily to your children instead of charity?

Giving appreciated securities outright to your children is an option, and for estates under $5 million (or $10 million for couples) the gift would be covered by the unified credit, and no gift tax would be due. Larger estates would benefit from techniques that preserve the unified credit for future use, but many of these strategies don't work well with appreciated securities, since the securities often must be sold, thereby generating immediate income tax consequences. One strategy, the Family Charitable Remainder Trust (FCRT), combines the income tax benefits of charitable planning with the estate tax benefits of standard estate planning techniques.

The FCRT allows a client with appreciated securities and a desire to both diversify his portfolio and pass wealth to successive generations to achieve both goals without immediate income

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Grimwade, N. (2000), International trade: new patterns of trade, production and investment. Routledge, London. Maddison, A. (1970), Economic Progress and Policy in Developing Countries. Allen and Unwin, London. OECD (2010), Perspectives on Global Development 2010. OECD, Paris. Reynolds, L.G. (1983), "The Spread of Economic Growth to the Third World: 1850-1980", Journal of Economic Literature, Vol. 21, No. 3, pp. 941-80. Rostow, W.W. (1960), The Stages of Economic Growth: A Non-Communist Manifesto. Cambridge University Press, Cambridge.

4 Rostow (1960), Maddison (1970), Reynolds (1983).

tax or gift tax consequences. Additionally, the FCRT provides an immediate income tax charitable deduction and a significant benefit to the client's favorite charity, which can even include the client's own private foundation.

While the structure is novel, it combines three well-established techniques:

- a family limited partnership,
- a charitable remainder trust, and
- a sale to a defective grantor trust.

Understanding the FCRT requires a basic understanding of these three techniques.

Family Limited Partnership

Family limited partnerships (FLPs) facilitate wealth transfer without loss of control. A client will typically create the partnership (which can hold real estate, securities or other assets) and later transfer or sell the limited partnership interests to family members (while holding on to the general partnership interest). Because the transferred limited partnership interests have no right to control the underlying assets, the transfer garners a discount that reduces the overall value of the interests for gift tax purposes. While the IRS has sometimes challenged fractional interest discounts, to date these efforts have been unsuccessful in eliminating their use for properly maintained entities.

Charitable Remainder Trust

A charitable remainder trust (CRT) allows a client to defer recognition of income tax on the sale of appreciated securities for several years while simultaneously receiving an income stream and benefitting charity. The client contributes appreciated property to the trust in exchange for the right to receive a fixed percentage of the trust assets for life or for a period of years. Once the income stream ends, the remaining assets in the trust are transferred to charity.

The charitable component makes the trust tax-exempt. As a result, selling the appreciated securities does not result in immediate income tax; rather, the client recognizes income only upon distributions from the trust. Moreover, the client receives an up-front income tax deduction typically equal to about 10% of the contributed assets. The CRT's income tax benefits only partially offset the often large remainder passing to charity, making CRTs appropriate only for clients with significant charitable intent.

Sale to Defective Grantor Trust

A "defective" grantor trust is merely an irrevocable trust containing certain provisions that cause the trust's income to be taxed to the grantor (the creator of the trust). A sale of appreciated securities to the trust in exchange for a promissory note does not result in any income or gift tax. As a result, all appreciation on the securities (in excess of the low interest rate on the note) accumulates in the trust and is excluded from the grantor's estate, thereby reducing the grantor's estate tax. The appreciated securities are eventually sold (incurring a large capital gain) and the sale proceeds used by the trust to repay the interest and principal on the promissory note. For this reason, the technique is not ideal for taxpayers with appreciated securities who are averse to selling the securities and recognizing gain.

Family Charitable Remainder Trust

The Family Charitable Remainder Trust (FCRT), in its most simple form, combines the three techniques outlined above to achieve tax-efficient diversification and effective wealth transfer to family, with a meaningful benefit to charity in the future.

Step 1 – Establish trust. The client establishes a defective grantor trust, usually for the benefit of their children and grandchildren, and seeds it with a cash gift.

Step 2 – Asset identification. The client creates a family limited partnership and adds highly appreciated securities that need to be diversified.

Step 3 – Charitable gift. The appreciated securities, now housed in the FLP, are transferred to a charitable remainder trust in exchange for a twenty year annuity equal to approximately 11.5% of the annual value of the trust.

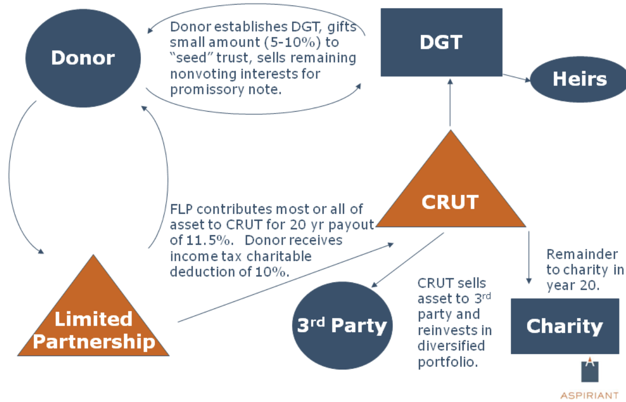
Step 4 – Sale. The client sells a 99% interest in the FLP to the grantor trust in exchange for a promissory note. The grantor trust now owns the FLP, which is the beneficiary of the charitable remainder trust.

Step 5 – Diversification. The charitable remainder trust sells the securities income tax-free, purchases a diversified portfolio, and uses the proceeds to make the annuity payment to the FLP.

Step 6 – Repayment. Each year for 20 years, the charitable remainder trust makes annuity payments to the FLP, which subsequently distributes them to the grantor trust. These payments are taxable to the clients, primarily as long-term capital gain. The grantor trust then makes interest and principal payments to the clients, retiring the note, often in about ten years. Distributions from the FLP in years 10-20 accumulate in the grantor trust, to be held for the client's heirs, gift-tax free.

Step 7 – Termination. At the end of the charitable remainder trust's twenty-year term, any assets remaining in the CRT pass to charity.

Family Charitable Remainder Trust



Case study – the FCRT in action

An example will clarify the type of situations where a FCRT is most effectively used.

Lauren Smith has $10 million of Apple stock acquired in 2004 for $1 million. She wants to diversify her holdings but doesn't want to immediately recognize the entire $9 million capital gain. She has a family foundation and some charitable giving goals, but she prefers to pass the majority of her estate to her children and grandchildren; consequently, giving the shares outright to charity is not a good option.

Instead, Lauren deposits the Apple stock into a family limited partnership and sells 99% of the partnership to a defective grantor trust, which Lauren had established for the benefit of her heirs and seeded with an initial $750,000 gift. The partnership garners a 25% fractional interest discount, so Lauren receives a low interest rate note back for approximately $7.4 million. The partnership donates the Apple stock to a charitable remainder trust, which sells the stock income tax free. Lauren receives an immediate $1 million income tax charitable deduction.

The charitable remainder trust, now holding a $10 million diversified investment portfolio, pays an annuity of approximately 11.5% of the CRT account balance each year ($1.1 million in the first year, assuming the portfolio returns about 8% per year). The grantor trust uses this income to pay interest and principal on the $7.4 million note, retiring it in as little as eight years. The remaining 12 years of distributions accumulate in the grantor trust for eventual distribution to Lauren's heirs gift tax-free.

Tax Loss Harvesting Explained

Our recent communications have mentioned that one of our responses to sharp downward market movements has been to do "tax loss harvesting". Clients who've been with us for more than three years have been through this drill before; however, it's been a while since we've harvested losses for most clients, and it's brand new to our newer clients, so we're providing a brief overview of this activity and why it's important.

When an investment declines in value and you sell it, a capital loss is recognized for tax purposes. This loss is an economic asset which can be carried forward until used to offset capital gains from the sale of portfolio holdings or other capital assets (e.g., your home). Consequently, during periods of market volatility such as we're witnessing now, we proactively harvest losses in the portfolio to offset future capital gains and, in doing so, significantly reduce future taxes and improve after-tax portfolio performance. In fact, recent research suggests that tax loss harvesting might add as much as 0.5% per year to after-tax portfolio performance.

A tax rule called the wash sale rule prevents us from repurchasing the same investment within 30 days of recognizing a capital loss. Long-term investors don't want to be out of the market for 30 days because of the risk of missing the rebound. Accordingly, when we sell an investment at a loss, we simultaneously purchase in its place an investment with similar characteristics.

For example, a client owns $100,000 of the DFA Tax-Managed Marketwide Value fund, which then declines by 20%, resulting in a $20,000 capital loss. We would sell the DFA fund – capturing the loss for tax purposes - and purchase a replacement fund, the iShares Russell 1000 Value fund, a close, but not exact, proxy that we expect will perform similarly to the DFA fund. The client continues to have exposure to the equity market (ensuring that they'll participate in a rebound) and they've "banked" a $20,000 capital loss that will offset future capital gains. After 30 days, we're free to sell the replacement fund and repurchase the preferred fund. In the event the market has rebounded sharply during the 30 day holding period, we may decide to retain the replacement fund indefinitely rather than recognize the gain.

If banked capital losses exceed capital gains in any year, clients can use up to $3,000 of the banked capital loss to offset "ordinary" income such as wages. The remaining losses carry forward to future years, so we actively harvest losses even in years when there are likely to be few gains.

We recognize that periods of short-term volatility can be very uncomfortable to endure, but they are an inevitable part of investing in equities. Tax loss harvesting gives us an opportunity to squeeze some benefits out of these difficult periods.

Distributions accumulate in the grantortrust income tax-free (Lauren is responsible for any income tax), so the trust could accumulate as much as $13.5 million by the end of the 20 year term.

Lauren's private foundation receives the balance of the charitable remainder trust after 20 years, which could be as much as $5.2 million.

In summary, Lauren has:

- Diversified a $10 million concentrated stock position with no immediate tax consequences,
- Obtained a $1 million income tax charitable deduction,
- Transferred as much as $13.5 million to her heirs over 20 years,
- Transferred as much as $5.2 million to her family foundation, and
- Received proceeds from the stock sale totaling $7.4 million,

While simultaneously:

- Using only $750,000 of her lifetime gift credit (preserving $4.25 million to be used in the future) and
- Potentially saving $5 million of estate taxes and another $5 million of generation-skipping transfer tax savings.

This all assumes an 8% pre-tax rate of return on the diversified investment portfolio. A return higher than 8% would result in even greater benefits for the children and charity.

Other considerations

While the FCRT combines several well-tested techniques, it is not a simple strategy and involves additional risks. The most likely challenge arises from the fractional interest discount taken on the limited partnership, but the strategy itself has passed IRS scrutiny in our office. However, it's generally appropriate only for large transactions and situations where the client is likely to be subject to estate tax liability. In the right situation, the FCRT can be a powerful tool, allowing a client to diversify an appreciated stock position without immediate income tax, transfer a significant amount to heirs, and provide a material benefit to charity.

Clay Stevens, JD
Director - Strategic Planning, Principal

Lifetime unified credit – The amount one can give away during lifetime or at death free of estate and gift taxes. Currently, the credit is $5 million per person ($10 million per couple).

Circular 230 Disclosure:
To assure compliance with Treasury Department rules governing tax practice, the Treasury Department now requires that all tax advisors attach the following statement to any and all written communication, except to the extent exhaustive steps are taken to satisfy the new guidelines of the regulation. We hereby inform you that any advice contained herein (including in any attachment) (1)
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