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THE FIDUCIARY GROUP
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Entrepreneurial Estate Planning

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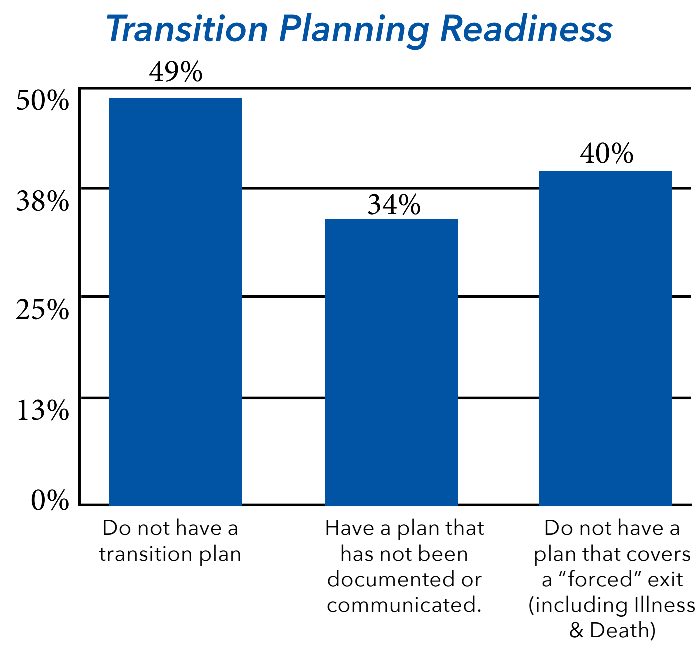
Over the years, a number of clients and friends have approached me to assist them with their estate planning needs. Because my legal license is inactive, I don't draft estate planning documents. However, with over 30 years of experience in administering estates and trusts, I can often bring an insightful vantage point to the estate planning discussion. Interestingly, most of the people with whom I have recently been consulting are current or former business owners. Out of our discussions, a couple of common themes have emerged.



Source: 2013 "State of Owner Readiness" Survey, Exit Planning Institute

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Much of the time, an entrepreneur's business(es) comprise the largest asset in his/her estate. Owning a successful business ordinarily means attractive equity distributions. The owner usually wants to continue owning the business for as long as possible in order to maximize the recurring cash flow. At a certain point, however, the attractiveness of cash flow from the business must be weighed against the health, age, and working performance of the owner.

This is the point at which the business owner needs to have an estate plan in place, not just for him or herself personally, but for the business. Estate planning for a business is succession planning…the process by which executive leadership is groomed to succeed the business owner when the time is right. Unfortunately, too often appropriate succession planning has not been formulated and implemented in the business, thereby potentially causing great disruption if the owner suffers an untimely death or disability.

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Entrepreneurial estate planning involves decisions on when and how to monetize the value of the business. Having a succession plan in place provides greater flexibility with respect to the timing of the monetization event.

Estate planning also requires a critical analysis of the business owner's liquidity. This means identifying the assets which will provide sufficient liquidity (cash flow and easy conversion to cash) to meet the owner's financial commitments (including liabilities related to other assets) as well as to meet the needs of his or her beneficiaries.

"Staying on top of a range of private equity investments requires considerable time and management skills which the entrepreneur's beneficiaries and/or successors may not have in order to properly safeguard their values."

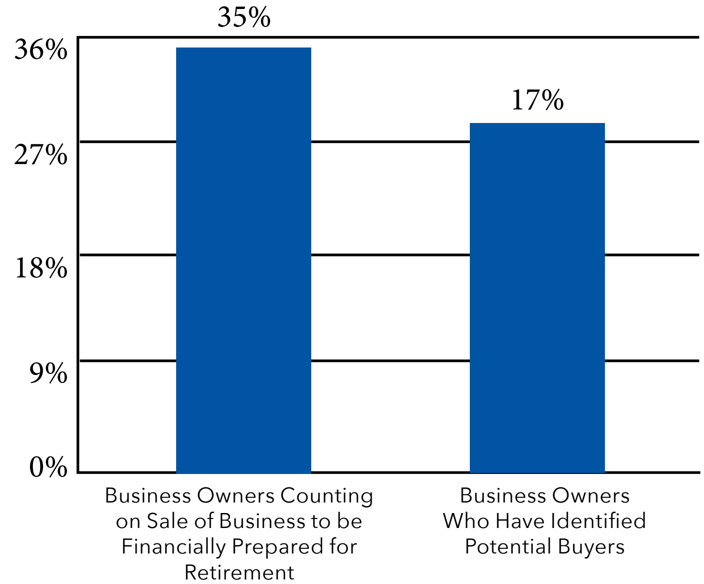
Related to the liquidity issue, there is another common theme I've found in the personal financial statements of many business owners. Often a great many closely held business interests (LLCs, real estate partnerships) are listed among the entrepreneur's assets. From an estate planning point of view, there are several drawbacks with a financial statement which is heavily allocated to closely held ventures. It is oftentimes difficult to value the business (valuations are subjective), and equally difficult to calculate the return on investment. Such investments typically take years to be monetized and/or realize any significant returns. Also, these assets are not liquid and may even be cash flow negative and/or require untimely capital calls. Staying on top of a range of private equity investments requires considerable time and management skills which the entrepreneur's beneficiaries and/or successors may not have in order to properly safeguard their values.

As business owners reach the last third of their lives, it is time for them to put a plan in place for the time they are no longer in active management mode, whether from retirement, death, or diminished capacity.

Here are some questions to consider:

1. Do you have a documented succession plan in place for your business? Does that succession plan ensure the continued valuation of your business for your beneficiaries in the event of your death or disability?

Owner Readiness for Sale of Business



Source: Guardian 2014 Small Business Owner Retirement Readiness Study

2. When is the right time to sell your business? If you wait until retirement, you may not be able to sell your business when you want or for the amount you want.

3. Apart from your business, what portion of your assets are tied up in closely held businesses, and how will those be managed in the event of your death or impaired ability?

4. How much cash flow will your assets generate to meet the needs of your beneficiaries and the financial obligations associated with your holdings?

I have a clear bias toward investment portfolios populated with publically traded securities that generate total return (interest, dividends, gains). Not only do they provide liquidity and cash flow, but the management of financial assets can more easily be delegated to professionals than can closely held business assets. From the vantage point of the business owner's beneficiaries, there is probably a strong rationale to eventually achieve a nearly 100% allocation to public securities among investment assets.

Business risks can be mitigated with a well-planned succession plan or with the sale of the business. Investment risks can be delegated to a professional investment advisor who can build a liquid and diversified portfolio of publicly traded equity and debt that will produce cash flow through all business conditions. Entrepreneurial estate planning should encompass both types of risk management.

Search For Yield Continues

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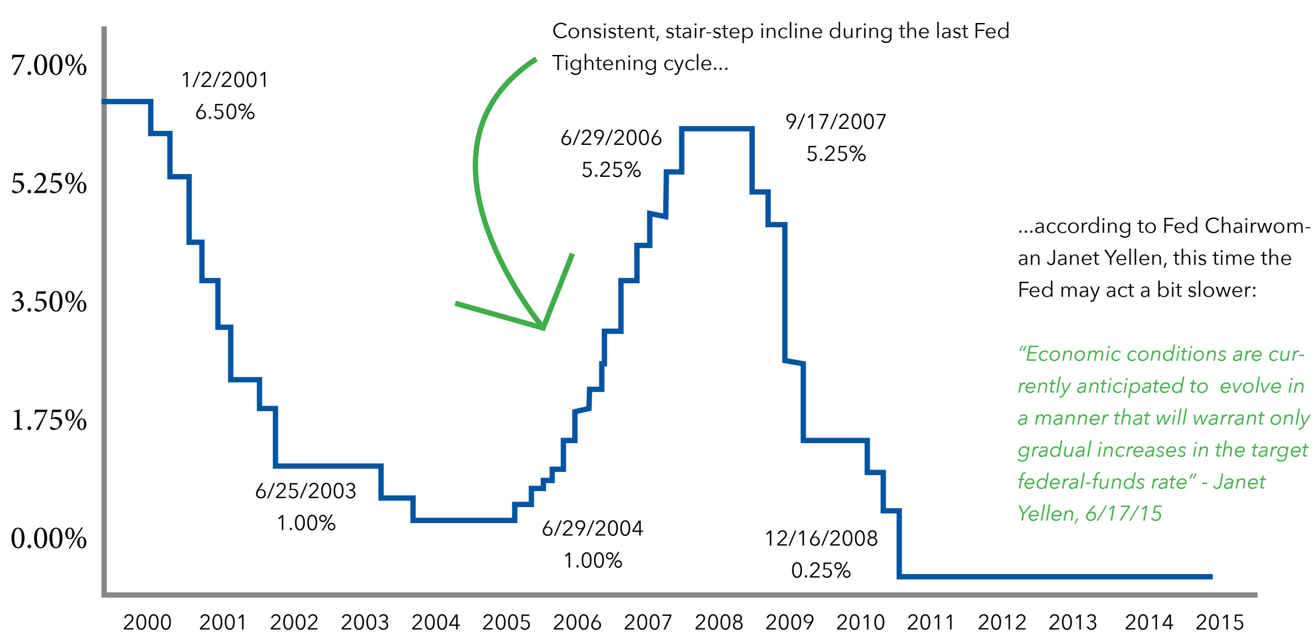
As with most investors, our goal is to maximize the total return that we receive from an investment (within a risk-adjusted framework). Total return is comprised of two components: 1) the income received (interest from fixed-income investments and dividends received on equity investments), and 2) the capital appreciation due to the change in the market value of an asset. In theory, investors should be agnostic as to whether their total return is derived from income or capital appreciation (as long as long-term goals are being met), but for retirees who are living off of their portfolio and for pension funds and insurance companies that have to meet current and future liabilities, there is a real benefit from generating income.

The saying, "a bird in hand is better than two in the bush" aptly describes the appeal of income over capital appreciation as it connotes certainty. In addition, the return from the income portion of a portfolio is usually deemed to be more consistent and reliable than valuation gains. Thus, investing in income generating assets intuitively makes good sense, and investors often gravitate toward said investments. However, persistently low interest rates over the last several years have resulted in a premium being placed on income producing assets, and the search for yield has become increasingly difficult, particularly in the fixed income space.

Against the backdrop of a likely increase in the Federal Funds rate this year, we thought it would be interesting to address the landscape for income and yield from both an equity and fixed income perspective. We'll start with an overview of the current yield environment and then discuss where we see opportunities and risks as we transition to less accommodative monetary policies in the U.S.

One of the primary drivers of the bull market in bonds since the financial crisis has been the reduction in the Federal Funds rate from 5.25% in September 2007 to a 0.00%-0.25% target in December 2008, where it has since remained. Long gone are the days when one could earn close to 5% on money market funds! Savers have been receiving close to zero percent on their cash for some time, and this paltry return is one of the reasons that investors have been willing to extend investment horizons and accept added credit risk in order to obtain yield.

Fed Funds Rate - 15 Year History

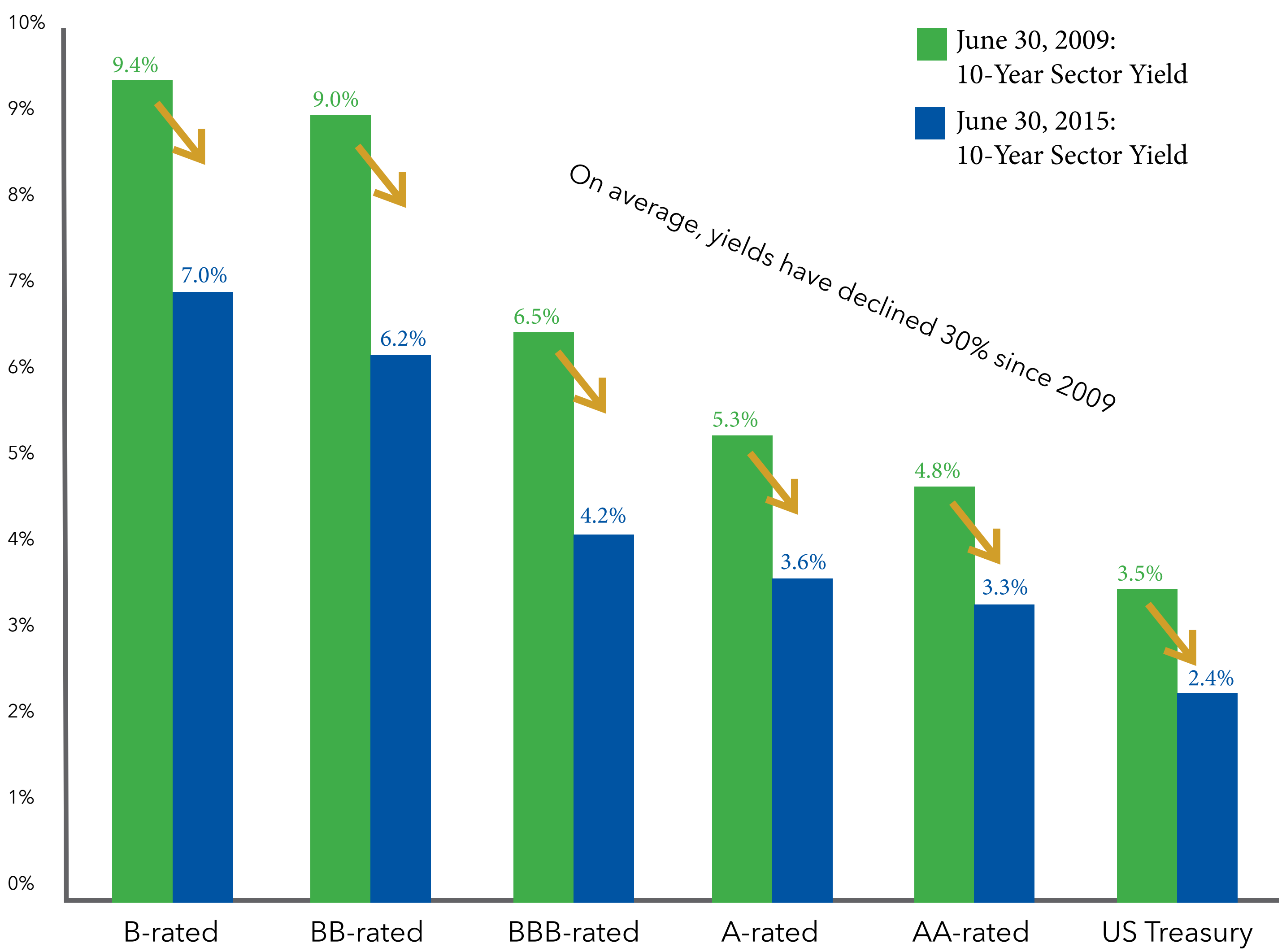


Source: Bloomberg, TFG

We can see this behavior borne out in the chart below which compares 10-year yields along the credit-risk spectrum as of 6/30/09 with yields as of 6/30/15. The yield on the U.S. Treasury security has compressed from 3.5% to 2.4%, a difference of 1.10%. Interestingly, the yields on BBB (investment-grade) and BB (non-investment grade) rated bonds have declined by 2.3% and 2.8%, respectively, reflecting not only spread tightening between the two periods, but also a willingness by investors to sacrifice credit quality for comparable yield. In plain language, investors who required a 6.5% yield for investment-grade paper in 2009 are now willing to accept a lower 6.2% yield for a non-investment grade security. For that matter, nominal yields are lower across the credit spectrum.

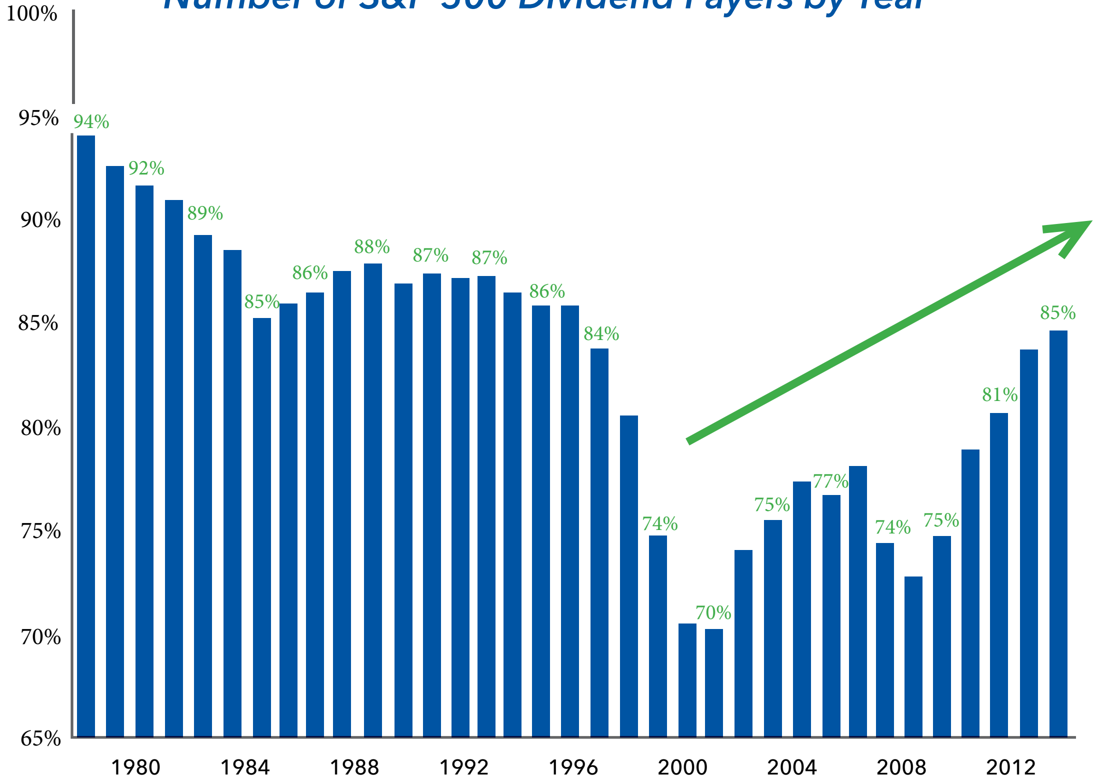
The skimpy rates in fixed income have led many income oriented investors to the equity market in search of yield. Strong operating fundamentals and low interest rates over the last few years have translated into healthy balance sheets and robust cash flows for corporations. As a result, an increasing number of companies are rewarding shareholders through dividends. As the chart on the next page shows, 85% of the companies in the S&P 500 Index pay dividends, up from 75% a decade ago. We expect this trend to continue in tandem with improved economic conditions and demand from additional retirees. The leading edge of the 65-million-member baby boomer cohort turns 70 next year, and we would expect income generation to be at the top of their list.

Comparative Bond Yields by Credit Rating (2009 vs. 2015)



Source: Bloomberg, TFG

Number of S&P 500 Dividend Payers by Year



Source: Standard & Poors, TFG

Companies also have ample resources to increase dividend payments, which should continue to attract investors. One measure of dividend paying capacity is the dividend payout ratio, which measures the percentage of earnings paid to shareholders in dividends. As the chart below shows, the average ratio for the S&P 500 Index is 35%, a very sustainable level with room for growth, in our view. Yields across sectors are attractive, and the average dividend yield of 2.1% on the S&P 500 Index is appealing relative to the 10-year Treasury bond's yield of 2.4%.

As the Fed prepares to raise short-term rates, both stock and bond market investors should expect increased volatility. Volatility can create opportunity when viewed rationally. The pertinent questions for investors to ask are: how much will rates rise, how fast will they rise, and how will the shape of the yield curve change? Of course, these are difficult questions to handicap, but understanding how and why different securities may be affected by the pace and magnitude of changing rates is a good starting point for assessing portfolio risks and opportunities.

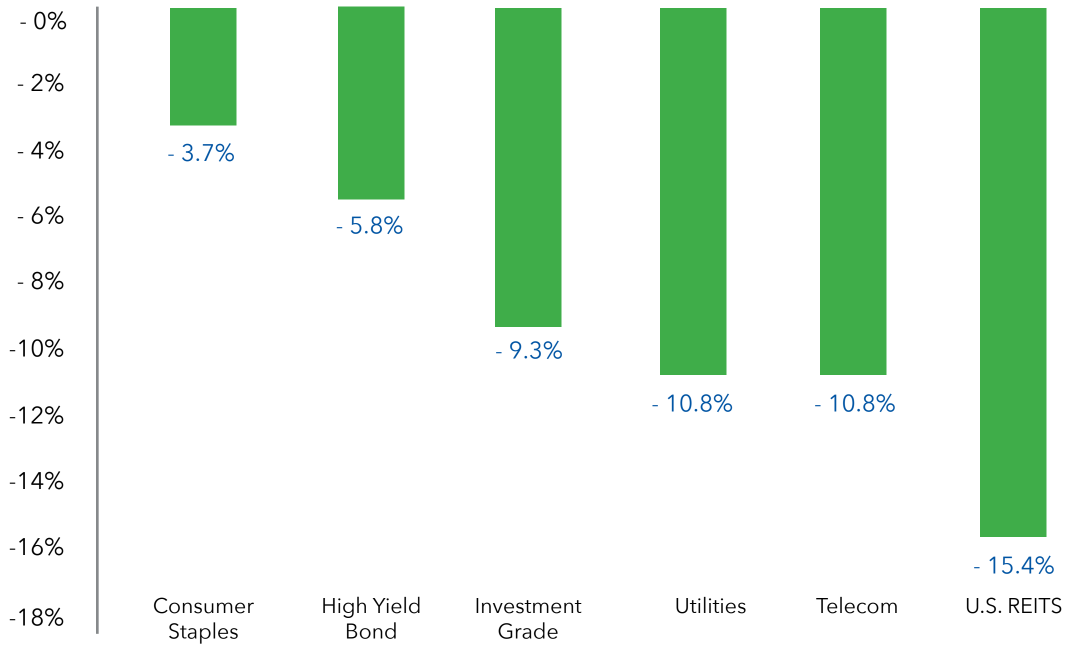
S&P 500 Dividend Yield & Payout Ratio by Sector

	Dividend Yield	Payout Ratio (Sorted)
Financials	1.9%	25.7%
Technology	1.6%	27.2%
Consumer Discretionary	1.5%	28.9%
Health Care	1.6%	32.6%
S&P 500	**2.1%**	**34.9%**
Industrials	2.3%	36.6%
Energy	3.1%	36.9%
Materials	2.1%	40.5%
Consumer Staples	2.7%	51.9%
Utilities	3.9%	60.3%
Telecom	5.0%	106.6%

Source: Strategas Research Partners, Bloomberg

Sectors Negatively Impacted by '13 Taper Tantrum

(Performance from 5/2/2013 to 9/5/2013)



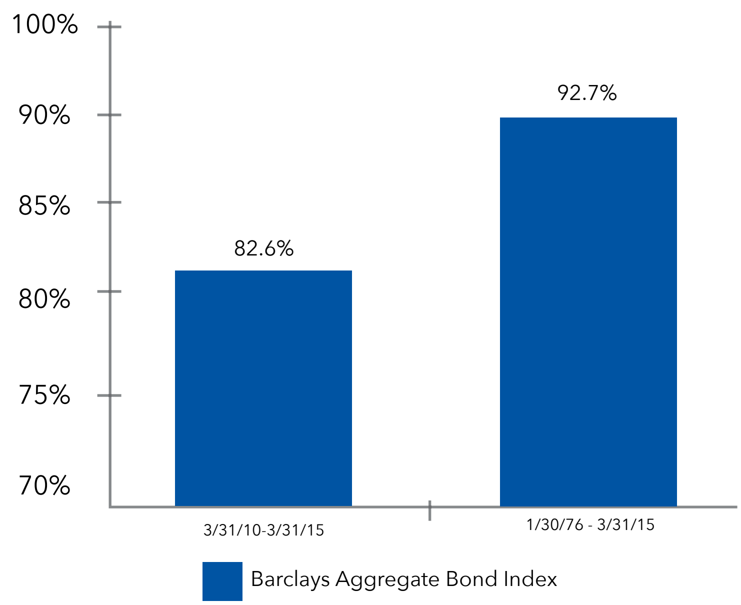
Source: Strategas Research Partners, TFG

During the period from May 2013 to September 2013, we witnessed a relatively quick upward surge in long-term rates and a steepening of the yield curve as the 10-Year Treasury bond's yield rose from 1.6% to 3.0% in response to communication by the Federal Reserve that it would begin tapering its purchases of long-dated U.S. Treasury securities. How different securities reacted during this period is instructive. As the chart above shows, the high yield bond sector fared relatively well, while high yielding stock sectors (REITs, telecommunications, utilities) suffered the most on a relative basis. Certainly, stocks tend to be more volatile than bonds, so that is part of the explanation. But, there are two other reasons we will posit. First, high yield bonds by virtue of their high coupon have a shorter duration, making them less sensitive to rising rates than their high yield equity counterparts. Second, the high yielding equities had been the beneficiaries of a flight to yield, so valuations were stretched in our view.

While not a prediction, our best guess is that the dovish nature of the Federal Reserve and the inconsistent recovery mean that the path to higher rates via a rise in the Federal Funds rate will be gradual. In contrast to the example above, we would expect the yield curve to flatten modestly as short-term rates go up more than long-term rates. When positioning portfolios, we would be buyers of both equity and fixed income in order to generate income. On the equity side, we favor companies that have the ability and intent to grow their dividends.

We would also be attracted to higher yielding equities on an opportunistic basis, especially if we experience another rapid move in rates. When evaluating bonds, patience is still important. While modestly higher money market rates will be welcome, managing credit and interest rate risk remains our focus. The low current yield environment leads us to continue to favor credit exposure rather than duration, as we seek to generate yield and minimize interest rate sensitivity. Lastly, as the chart below shows, investors should be well served to rely on their periodic interest payments, as income rather than price has been the primary driver of fixed income returns over the long-term.

Contribution to Index Total Return From Coupon Income



Source: Nuveen Asset Management

Self-Funding A College Education

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Funding a child's or grandchild's education is a high-priority savings goal for many families. This article will answer a few important questions:

- How much will college cost?
- How much do I need to save to fund the estimated expenses?
- What types of accounts should I use to save for and pay for college?
- How should I invest the savings?

This article focuses on self-funding the cost of college. Other funding sources such as loans, grants, and scholarships, as well as tax credits for education expenses, are resources that families should explore, but they are beyond the scope of this article.

How much will college cost?

A good starting point to find out the current cost of colleges and how fast those costs are going up is collegecost.ed.gov, a site designed and maintained by the U.S. Department of Education. It allows users to compare colleges' tuitions and fees, net price, and other characteristics.

Once you know the actual cost of the college(s) under consideration and the average inflation rate for that college's tuition and fees, you can plug that information in to any number of college cost calculators available on the web. One such calculator can be found on bigfuture.collegeboard.org. If you don't have exact costs, you can use the average cost provided by The College Board for different types of colleges.

Average Annual College Cost, In Today's Dollars

4 year private:	$42,224
4 - year public (in-state):	$21,447
4 - year public (out-of-state):	$33,973

Source: bigfuture.collegeboard.org

The college cost calculator estimates the cost of college by the time a child enrolls. The factors which come into play are the annual college cost in today's dollars, the college tuition inflation rate (how much it goes up every year), the expected number of years of attendance, and the years until college. Here is an example of the output, applying the national average tuition inflation rate of 6%, an expected attendance of 4 years, and an assumption that the child is 5, thus 13 years away from enrolling. Assuming a continuation of the national average tuition rate, in 13 years the average private college tuition will have risen from $42,224 to $90,061, the average public (in-state tuition) will have risen from $21,447 to $45,745, and the average public (out-of-state) tuition will have risen to $72,462, up from $33,973.

Projected Cost of College for a Child Age 5

4 year private:	$393,981
4 - year public (in-state):	$200,116
4 - year public (out-of-state):	$316,993

Source: bigfuture.collegeboard.org

So the next question in our example is: how much do the parents of a 5-year old need to save every year to have funded the child's college education by the time the child is ready to go to college?

How much do I have to save each year?

If you are mathematically inclined, you can calculate the amount you must save each year to reach your total savings goals using a financial calculator (otherwise you can ask your investment advisor to make the calculation for you). In our example, N = 13 (how many years to save), i = 7 (assume annualized returns on the investments of 7%), FV = $393,981, $200,116, or $316,993 (the projected future cost, depending on which type of college), and PV = $0 (no savings thus far). The chart below solves for PMT (the required amount to save each year to reach the savings goal):

Amount to Save Each Year to Fund College in 13 years

4 year private:	$19,561
4 - year public (in-state):	$9,935
4 - year public (out-of-state):	$15,738

Source: bigfuture.collegeboard.org

What types of accounts should I use to save for educational expenses?

Parents can of course save to their own (taxable) investment account(s) for their children's education. There are several other types of accounts for funding educational expenses which offer some tax advantages:

Section 529 Plans: Most states sponsor a 529 plan, and in many states, you do not need to be a resident to participate (though non-residents do not benefit from any state tax deductions offered). Anyone can contribute to a 529 plan for a child (parents, grandparents, uncle/ aunt, friend).

The most popular variety of 529 plans is a qualified tuition plan. This is a tax-deferred investment account utilizing mutual funds (investment options differ from state to state). In 2015, up to $14,000 ($28,000 for married couples) per beneficiary qualifies for an exclusion from the federal gift tax. If the contribution exceeds this limit, the account owner may elect to treat up to $70,000 ($140,000 for a married couple) as having been made over a period of up to five years. Total contribution limits vary by state, ranging from $235,000 to $452,210.

Not only do the investments grow on a tax-deferred basis, but the money can be taken out on a tax-free basis if used to pay for qualified education expenses. Qualified expenses include tuition, room and board, travel, necessary equipment, and other costs. In addition, some states, including Georgia, allow contributions by residents to be deductible at the state level (Georgia allows a deduction of $2,000 per beneficiary on state income tax). Unused amounts may be rolled over to a 529 plan for another beneficiary from the same family without penalty.

Coverdell Education Savings Accounts (ESA): ESAs allow for non-deductible contributions up to $2,000 per year for each child up to the age of 18. Earnings on funds in the ESA are tax-deferred and distributions are tax-free provided they are used for qualified education expenses. Unlike a 529 plan, which may only be used for college, ESA distributions may also be used to pay for K-12 elementary education. However, the amount that can be contributed is reduced when a married couple's AGI reaches $190,000, and is eliminated when the joint filers' income reaches $220,000. ESAs must either be rolled over or distributed by the time the child reaches 30 years of age.

UGMA and UTMA: Anyone may also set up a custodial account for a minor child under either the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). There is no contribution limit to these accounts, and the funds may be used to pay for any expense for the benefit of the minor (not just qualified education expenses). Contributions are not tax-deductible, and earnings on the account are taxed to the minor. For those under 19 (age 24 if a student), in 2015 the first $1,050 of earnings is tax-exempt, the next $1,050 is taxable at the minor's rate, and any remaining income is taxed at the parents' rate. After age 19 (24 if a student), all income over $1,050 is taxed at the child's rate. At the age of majority, the assets are completely in the control of the child.

"Pursuing an aggressive strategy in the early years and gradually moderating your exposure to stocks as college age approaches should allow you to achieve an annualized return over that period of about 7% while appropriately managing risk."

How should I invest the savings?

The investment options available in Section 529 plans are determined by the state sponsoring the plan. Most of these plans offer a variety of risk-based balanced mutual funds as well as asset allocation funds based on the child's age (the glide-path allocation funds become more conservative as the child approaches college age). You can choose the appropriate investment at the time you set up the plan, as well as up to twice annually thereafter. Investment decisions for an ESA account are made entirely by the trustee (as directed by the donor), and the options are fairly broad as long as they don't violate the allowed investments for an IRA. Investment decisions for an UGMA or UTMA account are made by the custodian until the minor reaches the age of majority, and relatively few investment restrictions apply.

There are three important keys to balance in choosing an investment strategy: time horizon, return objectives, and risk tolerance. The longer the time horizon until the funds are needed, the more risk you can afford to take. Stocks historically have returned 8-9% with high volatility, and bonds have returned 4-5% with low volatility. The balance you choose between stocks and bonds will determine both the rate of return as well as the volatility of your investment portfolio. If you start saving to a college fund when the child is 3-5 years old, your time horizon is 13-15 years. Pursuing an aggressive strategy in the early years and gradually moderating your exposure to stocks as college age approaches should allow you to achieve an annualized return over that period of about 7% while appropriately managing risk.

Bottom line for all those saving for a child's education: start early; plan realistically; save to the plan; and invest appropriately.

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