GREENWOOD REPORT

INTERGENERATIONAL WEALTH TRANSFER: ADVICE FOR THE NEXT GENERATION

The shift in wealth from The Greatest Generation to the Baby Boomers to Generation X and today's *"Generation Now"* has unique implications for our client families. A study by Cerulli Associates, a leading research firm, estimates that $16 trillion of assets will be passed down to the next generation in the coming 35 years. Put in perspective, that is roughly equivalent to the annual GDP of the United States. This shift presents very real investment, tax, legal and social opportunities and challenges.

From Greenwood Gearhart's viewpoint, this demographic paradigm has been punctuated by the fact that **the accumulation of <u>financial assets</u> is somewhat new to Arkansas families,** especially when contrasted with other regions like the Northeastern United States. As a result of Arkansas' agrarian foundations, much of the state's historic wealth has been concentrated in land as opposed to financial assets such as stocks and bonds. But as the state has prospered financially, so too has its residents, resulting in significant wealth accumulated over multiple generations. Many of us know people who bought Walmart from "Mr. Sam" back when it was a regional discount chain, resulting in virtually zero dollar cost-basis. Early clients of Greenwood Gearhart hold other "blue chip" investments with similarly low basis lots.

As their financial assets have grown, so too have our client's desires to preserve their wealth and to pass it to the next generation both efficiently and responsibly. **Their concern centers equally on providing sound "advice" as well as actual dollars**. The most flattering statement we hear from long-term clients is: "*We were lucky to benefit from your advice thirty years ago and we want our heirs to benefit from the same*" or "*Will you spend some time with my son or daughter and talk to them about investing.*"

Of course, we always welcome the opportunity to meet the second and even third generation of the families we serve. We've held sessions with "children" both young and old, discussing concepts as rudimentary as how much Disney (DIS) profited from the movie "*Frozen*" to why Givaudan (GVDBF) is positioned favorably in emerging markets. Inevitably, the topic of **<u>responsible investing</u>** takes center stage in these meetings.

As a result, we take these discussions a step further. As the next generation of emerging affluent individuals joins our firm as clients, we spend a considerable amount of time advising on responsible investing strategies to help them plan for their retirement. This goes beyond just inheritance. We address the key tenants of building wealth over multiple generations by creating a "culture" of financial prudence within the family.

This Greenwood Report outlines some of those strategies by focusing on the basic pieces of financial advice that, we believe, are important for the next generation. It is meant to be a concise summary – **bullet points you can pass on to your children or grandchildren, or use yourself.** We

caution the reader however, financial planning is a highly complex and bespoke process that involves significant analysis of an individual's financial picture. These points are only the beginning. We encourage you to call if you'd like to review your personal situation or discuss planning for the next generation.

I. Start Early

Albert Einstein is credited with saying *"Compound interest is the eighth wonder of the world"*. In fact, the definition of compounding, in investment terms, refers to *the ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings*. In this virtuous cycle, the math is clearly on the side of the investor with the long-term time horizon.

To illustrate, consider two individual investors saving for retirement: a short-term investor and a long-term investor. The long-term investor starts investing at age 25 while the short-term investor waits until age 55. Both investors begin with $100,000 and earn 8% on their investment. **At age 65, the long-term investor earns ten times ($2.2 million vs. $216,000) the amount of money as the short-term investor and only invested for four times as long (40 years vs. 10 years).** Simply put, the long-term investor's money works harder due to the *accumulating earnings on earnings*.

II. Pay Yourself First

If you have access to a retirement plan through your employer, it is important to maximize your participation. **The definition of "maximizing" varies and depends on the type of plan in which you are enrolled**. However, some general rules of thumb are as follows:

a. In a basic plan, employers often will match your salary deferral into the plan, up to a certain amount. **If your employer provides you with this benefit, then maximize the match.** If you don't, you are leaving money on the table and foregoing a significant benefit of your employment. One common match is a 3% match on the first 3% of salary deferral. This effectively results in a 100% guaranteed return on your initial investment.

b. However, maximizing the match is only the beginning and as indicated, varies based on your plan's specifications. **To the extent you are able, consider maximizing the allowable IRS limits** which, depending on your income, may be higher than the amount required to maximize your employer's match. To illustrate, in 2015 the IRS will allow for a maximum before-tax annual salary deferral of $18,000 (plus $6,000 for individuals over 50), called the 402(g) limit. By maximizing this limit, you help to defer and minimize your current income taxes plus allow the

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tax deferral to compound over many years. Maximizing the 402(g) limit should be a goal of every young and mature employee alike.

III. Never Pay Taxes Until They Are Due

To us, this concept is best explained by the adage *"A bird in the hand is worth two in the bush."* When confronted with the choice of 1) **deferring** tax today only to pay when withdrawn at a future date (like through a 401(k) or IRA) versus 2) **paying** the tax today to receive tax-free income later (like through a Roth IRA) we choose the former. Interestingly, the math of the two options is identical. Considering the same rate of return, same time horizon, and same tax rate, the after-tax future value of both structures is equal. However, when any one of these variables change, the future value changes. Many proponents of Roth IRA's argue that your future tax rate will be higher in retirement, so pay the tax now. Maybe. **But today's tax deferral advantage is certain and, in our opinion, is not worth trading for the mere potential of tax savings at a future date**. This is especially relevant in an environment where the U.S. government may be looking for revenue.

IV. Get a Will and/or a Trust

Everyone needs a Will and/or Trust; this importance cannot be overstated. Too often we see situations where care and attention were not paid to estate planning, causing an administrative nightmare for our client's heirs or worse, the payment of unnecessary taxes. A Will and (depending on the complexity, accumulated assets, and need for privacy) a Trust, are not only important for the patriarch and matriarch of the family, but also the **receiving heirs**. In many cases, coordination across the family is appropriate for continuity purposes. While families can be hesitant to talk about money, it is important to involve adult children in these discussions. If you or your loved ones are lacking a will, consider giving this important gift for the holidays.

V. Debt Can Be a Beneficial Financial Management Tool

In today's record-low interest rate environment, debt can be an important aspect of personal financial management. As we have said in other reports (See September 2012 Greenwood Report), **it is an excellent time to be a borrower and a poor time to be a lender**. Just as our investment strategy has focused on equity as opposed to fixed income securities over the past few years, we encourage clients to evaluate the use of debt (like through a home mortgage) on their personal balance sheet for the following reasons:

a. Although leverage can be detrimental when abused, "positive leverage" means you can borrow at 3-4% for 15-30 years and have the capital to

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invest at higher expected rates of return, like through an investment portfolio.

b. Utilizing the capital markets, **corporations** regularly use long-term debt to finance growth of the enterprise. However, **individuals** have very few opportunities to borrow long-term outside of a home mortgage.

c. The illiquidity associated with real estate may make it hard to access the capital (equity) in your home in the event of an unexpected need. The opportunity to have your home paid for versus the flexibility of having a reasonable mortgage, plus an investment portfolio that could pay off your mortgage, is a financial management choice.

d. The Home Mortgage Interest Deduction is one of the few tax subsidies the Federal Tax Code provides to individuals. It frequently makes the difference between using the standard deduction and the more advantageous itemized deductions.

VI. Invest For Your Children

The most frequent reason for specifically investing for your children is for education. While there are many different options, the two most common are through a 529 College Savings Account and a custodial account, commonly called a Uniform Transfer to Minor (UTMA) account. We tend to favor the latter due to its flexibility and accessibility when compared to the 529 plan. Because the custodial account is not restricted to education expenses, the funds can be applied to alternative uses for the child's benefit. In our experience, we have seen it used for study-abroad, down payment on a house, automobiles, or weddings. In contrast, the 529 account must be used for higher education with stringent rules for how the assets can be withdrawn.

While both options utilize the annual estate gift exclusion, tuition and education expenses, if paid directly to the institution, do not count toward the annual exclusion. There are also technical differences in the transfer of ownership.

VII. Slow and Steady Wins the Race

Warren Buffett is credited with saying *"The market timer's Hall of Fame is an empty room."* Individual investors, as human beings, are wired to focus on the here and now, the instant gratification that the market can provide from time to time. They want to "move into" the market when things are good and "get out" when things go south. However, this behavior can be particularly detrimental to the long-term success of your portfolio – frequently, the result is buying high and selling low!

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The dangers of timing the market were highlighted by the firm Davis Advisors in their piece *"The Wisdom of Great Investors."* In a study of 20 year returns of equity investors (using the S&P 500 Index as proxy), Davis compared those who remained invested over the entire period to those who missed just the best 10, 30, 60, or 90 trading days. **The patient investor, who remained invested during the entire 20 year period, received the highest average annualized return of 9.2% per year.** Missing just the best 30 days resulted in a paltry return of only 0.9% per year. Missing 90 days was disastrous. Maybe the Tortoise really is faster than the Hare?

The Danger of Trying to Time the Market
20 Year Annualized Returns of the S&P 500 – 1994-2013

Stayed the Course	**9.2%**
Missed Best 10 Days	5.5%
Missed Best 30 Days	0.9%
Missed Best 60 Days	-4.4%
Missed Best 90 Days	-8.6%

Source: Bloomberg and Davis Advisors

VIII. Risk and Return Are Positively Correlated

Investment is placing capital at risk with the expectation of a gain, but the possibility of a loss. Risk is the uncertainty of the outcome and the probability of loss when unfavorable outcomes occur. **We believe it is important for any investor to approach risk cautiously, but to also embrace it as a source of investment return**. At Greenwood Gearhart Inc., we mitigate risk through hard work, knowledge, and diversification. We also believe that risk and volatility provide us with the opportunity to make profitable investments on behalf of our clients. The unwillingness to tolerate volatility (mistakenly characterized as a proxy for risk) can blind the investor to other risks which may hinder their portfolio. This is most commonly observed through purchasing power risk, whereby a particularly risk-averse individual invests heavily in cash and equivalents (currently earning near zero percent) in an effort to remove volatility from their portfolio. While they sleep better at night, the insidious nature of inflation erodes the purchasing power of the portfolio over time resulting in a drop in their standard of living because their assets at retirement are worth less.

IX. Plan to Live a Long Life

According to the World Health Organization, life expectancy at birth in the United States is age 79. To avoid outliving your assets, this ever-lengthening time horizon requires planning for the unexpected – an age of 100 years or more. In fact, the world's oldest

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documented person, a Japanese woman named Misao Okawa, is nearly 117 years old. She was born in 1898, ten years before the first Model-T rolled off Henry Ford's assembly line. Imagine how long a little girl born in 2014 might live? Additionally, although it isn't guaranteed, the IRS, at the urging of major life insurance companies, now use approximately age 100 as life expectancy for computing the Required Minimum Distribution (RMD) and annuity payouts.

These facts further punctuate the importance of **starting early** as highlighted in point I above. They also reinforce point VII that **slow and steady wins the race**. With a long time horizon, volatility which can seem schizophrenic in the short-term, washes away over time.

X. **Find Someone You Can Trust**

Greenwood Gearhart is the beneficiary of a highly loyal client base. For over 32 years, clients have trusted us with their wealth while remaining invested during both successful and challenging times. We believe the continuity of our staff (over 100 years of **firm** experience), the timelessness of our investment process, and our experience across market cycles is worthy of this trust. If not our firm, we encourage the reader of this piece to find someone **they** can trust. Then, utilize the basic principles outlined above to govern their long-term strategy.

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