Portfolio Strategies WORKSHOP

Incorporating an Inheritance Into Your Existing Portfolio

By Maria Crawford Scott

What do you do when you receive an inheritance? Unlike a lump-sum distribution of cash, inheritances may come to you in the form of an already-existing portfolio. Needless to say, the allocation of that portfolio is unlikely to match your own.

Individuals who receive an inheritance have one advantage—for tax purposes, the basis for the inherited assets is "stepped up"; that is, their basis is the market value at the time of the inheritance. Thus, if you decide to sell, at least you needn't worry about capital gains prior to the time you inherited the assets. However, there are other costs to consider.

One way to understand some of the investment considerations in dealing with an inheritance is by looking at an example—a case study of a typical situation.

Meet the Bakers

Henry and Alice Baker are in their 50s, and both of them are working. Because their two children have finished college, they have shifted their financial attention from their children's expenses to retirement savings.

The Bakers' savings portfolio (see Table 1) reflects their retirement savings focus: They have no immediate income needs, and are more interested in long-term growth. The asset allocation is designed to provide them with considerable growth—70% in stocks, including 11% committed to small-cap stocks and a portion of their international committed to emerging markets. Henry Baker also enjoys dabbling in the stock market, but he can't devote a lot of time to his analysis and therefore has a small portfolio of individual stock holdings. Once he retires, however, he plans to devote more time to stock investing, and hopes to increase his commitment to individual stocks.

The Bakers also want a small amount of stability in their portfolio, so they have committed 20% to bonds and 10% to cash. However, they have also been in a higher income-tax bracket, so instead of investing in a taxable bond fund, they have invested in a high-yield municipal bond fund, in which the income generated is tax-exempt. Similarly, their money market fund is invested in short-term tax-exempt assets. In addition, upon retirement, their overall fixed-income "commitment" will automatically grow because of a good-sized annual pension and Social Security payments the Bakers will receive. For that reason, they do not anticipate the need to shift any assets from their stock portfolio to bonds as they near retirement.

Unfortunately, Alice Baker's elderly mother recently passed away, and after the estate was settled, the Bakers found that they had inherited $90,000 worth of assets in the form of securities and mutual funds. The allocation of these assets (Table 1) reflect the elderly woman's own needs and circumstances—she needed current income to supplement her pension and Social Security payments, so she invested heavily in bonds using a taxable bond mutual fund (purchased three years ago); that left only a very small portion available for investment in a large-cap stock fund (also purchased three years ago). Both mutual funds are class B shares of a load fund family, which means that the load is paid in the form of back-end charges (which decline over a five-year period) and that the shares carry higher annual 12b-1 fees. However, she also owned a small portfolio of individual stocks—stocks that her husband had bought years earlier. Her husband had focused his attention on banking stocks (being a banker, he was familiar with the industry) and utility stocks to generate income. Alice's mother had been unsure of what to do with these stocks after her husband had died, so she had simply held on to the shares throughout the years.

Needless to say, the inherited portfolio is a particularly bad fit for the Bakers. Combining the inherited portfolio, as

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Table 1.
Integrating an Inheritance: A Case Study

The Portfolios

The Bakers' Portfolio		The Inherited Portfolio		Combined Portfolio	
Holdings	**Amount**	**Holdings**	**Amount**	**Asset Class**	**Amount**
Dodge & Cox Stock (Large-Cap)	$87,500	Smith Barney Inc & Growth (Large-Cap)	$9,000	Large-Cap Stocks	$96,500
Babson Enterprise (Small-Cap)	$27,500	5 Individual Stocks (Specialty)	$9,000	Small-Cap Stocks	$27,500
Schwab Intl Index (Int'l)	$22,500	Smith Barney Inv Grade Bond (Gen'l Bond)	$63,000	International	$35,000
T. Rowe Price New Asia (Int'l)	$12,500	Money Market Fund (Cash)	$9,000	Specialty	$34,000
7 Individual Stocks (Specialty)	$25,000			General Bonds	$63,000
Vanguard High-Yd Muni (Tax-Exmp)	$50,000			Tax-Exempt Bonds	$50,000
Money Market Fund (Cash)	$25,000			Cash	$34,000
Total	**$250,000**	**Total**	**$ 90,000**	**Total**	**$340,000**

The Asset Allocations

Asset Class	Baker Allocation (%)	Inheritance Allocation (%)	Combined Allocation* (%)
Stocks	**70**	**20**	**56**
Large-Cap	*35*	*10*	*28*
Small-Cap	*11*	*0*	*8*
International	*14*	*0*	*10*
Specialty	*10*	*10*	*10*
Bonds	**20**	**70**	**34**
General	*0*	*70*	*19*
Tax-Exempt	*20*	*0*	*15*
Cash	**10**	**10**	**10**
Total	100	100	100

**Numbers are rounded*

is, with their own portfolio produces a combination that strays quite far from their own needs, as shown in Table 1: Their stock commitment would decline from 70% to 56%.

In addition, the individual stocks of the inherited portfolio are incompatible with the Baker's needs and circumstances. For one, the holdings are in two industries in which Henry Baker has no knowledge. Secondly, they are in industries that do not fit with his investment style—he has primarily focused on smaller capitalization stocks that are not held in any of his existing mutual funds. The inherited stocks, on the other hand, are large capitalization stocks and likely to perform quite similarly to some of the stocks held in the Baker's largest mutual fund holding—the Dodge & Cox Stock fund. Lastly, the inherited stocks will generate taxable dividend income, which the Bakers at this point do not need and would merely reinvest.

The Bakers' bond commitment looks similarly problematic with the additional assets: Their bond commitment would rise to 34%, an overcommitment to stability that will only get worse upon retirement (with the addition of the annual fixed pension payments), and that will also increase their current tax bill, since the additional bond commitment is entirely due to investment in taxable bonds.

Clearly, some or all of the inherited portfolio may have to be sold, but there are some costs to taking these steps. First of all, there are transaction costs involved in selling and reinvesting any individual stocks. In addition, selling the Smith Barney fund shares would incur deferred sales charges, at least for another two years.

What should the Bakers do?

The best approach is to go through each asset and weigh the costs and benefits of selling versus hanging on to the investment. Here's how the Bakers analyzed their portfolio.

The taxable bonds: This would appear to be the most obvious candidate for sale, but the Bakers are also aware of the deferred sales charges, which don't disappear for another two years. Should they hold on to the fund until those charges disappear? They decide against it. First of all, the increase in their tax bill due to the taxable interest paid by the fund will most likely be higher than any deferred sales charges they would incur in a sale. Second, the higher annual 12b-1 charge associated with the Class B deferred sales charge shares will wind up costing the Bakers about the same amount at the end of two years as the deferred

sales charges today. Result: shares sold.

The Smith Barney Income and Growth fund: This would appear to be an asset the Bakers could hold on to, since their problem is an undercommitment to stocks, and selling this fund would incur a deferred sales charge at least for the next two years. Again however, the higher annual 12b-1 charge will wind up costing the Bakers about the same amount at the end of two years when the deferred sales charges disappear, so this cost is really a wash. In addition, the historical performance of the fund has been only so-so, and lower than the Baker's own large-cap fund, the Dodge & Cox Stock fund. The Dodge & Cox Stock fund also has lower annual expenses. High annual expenses are a drag on future performance, so even if the two funds had similar performances, the Bakers would tend to favor the Dodge & Cox fund. Result: shares sold.

The specialty stocks: Henry Baker knows absolutely nothing about banking or utilities and realizes that the analysis of these stock categories is different from the stocks on which he has focused. He would never buy "blindly" into an area with which he is unfamiliar, but on the other hand, he is loathe to sell "blindly," not knowing whether he is holding stocks with potential. Henry decides against an immediate sale, but sets a deadline of sorts—he will find out what he can about the industries and the individual stocks within the next few months and make a final decision then. [How will he examine the industry? In addition to the publications, such as Value Line and Standard & Poor's, that provide summaries on industries, he also will contact several mutual fund sector funds that invest in banking and ask for their most recent financial reports.] At that point, he expects to sell most of the shares, but perhaps remain invested in one or two stocks if they appear promising. Henry reaches this decision because he enjoys stock analysis and feels that he can develop enough expertise to reach an informed decision on at least one or two stocks; in addition, his individual stock holdings are not at this point a large part of his overall investment portfolio. Once he retires, moreover, he would like to devote more time to stock investing—and commit a larger portion of his portfolio to individual stock investing, and so broadening his knowledge slowly now is an "investment" of sorts in his retirement. If he had had no interest in stock analysis either now or later, Henry would have sold the inherited individual stock portfolio. Result: shares are retained.

Divvying Up the Sale Proceeds

The final outcome is that the Bakers have decided to sell both Smith Barney funds—a total sale of $72,000. The proceeds from the sale will be invested in their money market fund, and over the course of the next year they will dollar cost average it into their current holdings.

How do they apportion the $72,000? Actually, they are really apportioning the entire $90,000 according to their original asset allocation:

- The large-cap fund is 35% of the Baker's original portfolio, so $31,500 (35% of $90,000) will be invested in the Dodge & Cox stock fund.
- The small-cap fund is 11% of the original portfolio, so $9,900 (11% of $90,000) will be invested in Babson Enterprise.
- The international funds are 14% of the original portfolio, so $12,600 (14% of $90,000) will be invested in Schwab International ($8,100) and T. Rowe Price New Asia ($4,500).
- The municipal bond fund is 20% of the original portfolio, so $18,000 (20% of $90,000) will be invested in the Vanguard High-Yield Municipal Bond fund.
- The individual stock holdings and cash comprised 10% each of the original portfolio; the inherited portfolio has the same allocations and the Bakers are holding on to the inherited stock holdings for the time being, so nothing further needs to be done.

Final Thoughts

The Bakers incorporated their inheritance by selling a good portion of the assets, but obviously every situation is unique. Here are some guidelines to keep in mind when trying to incorporate inherited assets:

- Examine the inherited holdings individually, evaluating each one the same way you would a prospective investment.
- If the asset is an investment that fits your needs and meets your criteria, the decision is relatively simple—you should hang on to the asset.
- If the asset clearly does not meet your needs or you do not have the investment knowledge required to manage the asset and have no desire to acquire this knowledge, you should probably sell the asset regardless of transaction costs.
- If it is a close call—for instance, the asset fits your criteria but you already hold a similar asset—you will have to weigh the possible costs of a sale against the cost of remaining in an asset to which you are indifferent.
- Don't hold on to an inherited asset simply because it was purchased by the person from whom you inherited it, who most likely is someone you deeply cared for. Everyone has different needs and circumstances, and you are not questioning their abilities by preferring to sell the asset. It is possible, for instance, that the person from whom you inherited the asset had decided that the asset no longer met her investment criteria but had substantial capital gains, and with a short life expectancy felt it would be more advantageous to avoid capital gains taxes by leaving it as part of an estate.