

# INHERITED STOCKS RAISE ISSUES FOR COUPLE NEARING RETIREMENT AGE

By Clark M. Blackman II

In this issue's portfolio makeover, financial planner Clark Blackman writes a planning letter to Timothy Smith addressing his financial concerns and, in particular, his upcoming retirement and what to do with a major inheritance.

## INVESTOR PROFILE

- "Tim," age 58, is a do-it-yourself investor and considers himself a moderate risk taker, but has limited investing experience, almost exclusively in stock mutual funds.
- Tim is an internal auditor with two more years until he is eligible for his retirement pension.
- Tim's wife, "Mary," is a homemaker, very conservative with money matters (according to Tim) and no investment experience. She has no retirement pension.
- Tim and Mary live very modestly and are big savers.
- They have no children; both are in good health.
- Tim has inherited a significant amount of cash as well as a portfolio of 20 individual stocks.

*To: Mr. Timothy Smith  
The Midwest, U.S.A.*

## PLANNING ANALYSIS

In the course of our various conversations, you indicated to me several minor concerns and two major ones. First, the minor concerns.

### **Should you get long-term health care insurance (LTHC)?**

Yes, absolutely, get long-term health care coverage. It is still very affordable at your age and will cost you about \$2,000 to \$3,000 per year depending on bells and whistles.

### **Will you be able to afford major medical insurance to replace your current company coverage?**

You absolutely need to have medical insurance, and your good health (and Mary's good health) and the fact you're both non-smokers bodes well for "affordable" coverage. My firm's research indicates you and Mary could get Preferred Provider Network coverage for about \$900 a month, or \$10,000 to \$11,000 per year—that's a lot, but you can't afford to be without it. Fortunately, you only need it until you reach age 65 and qualify for Medicare. Your Medigap coverage would then run about \$1,300 a year (in today's dollars). In any event, you should shop around.

### **What should you do, longer term, about your very low basis rental property in terms of reducing taxes on sale?**

One possibility on the rental property is a "Section 1031" tax-free exchange. This would allow you to acquire a property closer to home that

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*Clark M. Blackman II, CPA/PFS, CFP, is managing director and chief investment officer of Investec Advisory Group, 1001 West Loop South, Suite 800, Houston, Texas 77027; 713/622-9111.*

might generate a higher level of income. A better solution would be a charitable remainder annuity (or unit) trust (GRAT or GRUT). [For more details, see “The Use of Trusts in Charitable Giving,” by Clark Blackman in the June and August 1993 *AAIL Journals*; available at [AAIL.com](http://AAIL.com).] I think you’ll find this has some very appealing benefits with little downside—the property does eventually go to a charity following both of your deaths, but since you do not have direct descendants/heirs to your estate, that may not be a downside for you at all.

### Is there enough to retire on for the next 30 years?

One of your big concerns, quite predictably, is whether you have enough assets to see you comfortably through for the next 30 years.

Fortunately for you, the answer is a fairly straightforward: Yes.

However, this assumes you do nothing impulsive like buy a yacht or an airplane. If you keep to the standard of living you have established for yourselves, spending \$50,000 per year, and you spend some additional amounts for the next few years for travel and entertainment (say \$8,000 to \$12,000 a year until you’re 70), then a reasonably conservative strategy of investing should allow you to live out your retirement with little worry.

I ran a variety of different retirement cash flow scenarios, and found that even assuming a very conservative 3% rate of return on your assets, the expected balance would be \$631,000 at age 90 in 2035, which is equivalent to about \$237,000 in today’s dollars.

### THE INVESTMENT PORTFOLIO

Now for the really important question—how should you invest your retirement nest egg for the next 30-some years?

#### Asset Allocation

What is the most important decision any investor makes regarding their portfolio? If you didn’t guess “asset allocation,” then take that as a sign that there are some very fundamental investment principles you need to learn. In 1986, and again in 1991, a group of financial analysts published results of a study showing that well over 90% of the risk and return characteristics of portfolios were a function of the allocation decision—not security selection and not market timing. Other studies have since refuted the 90% figure, but the evidence all points to this: No less than two-thirds of your long-term

### GOALS

- Tim wants to retire at age 60, if possible.
- Tim wants direction on how to invest the inheritance of cash and individual stocks.
- Tim and Mary would like to sell their current residence and move to another state at retirement.
- They have a low basis rental property and need ideas on how to reduce taxes when it is sold.

### LIKES AND DISLIKES

- Tim dislikes brokers; his limited experience with them was unfavorable.
- They believe they have done well with mutual funds.
- Tim has no experience managing individual stocks and no experience with bonds.

return will be dictated by how much of your portfolio you allocate to various asset classes and sub-classes.

That being the case, the first thing you need to determine is how to spread your assets around, and then, and only then, focus on how the securities will be purchased.

Your current allocation of cash, stocks and real estate, assuming they are adequately diversified—which they are *not* (and I will address this issue later)—leads to a portfolio with a return potential of 9.02%. In truth, this portfolio is too aggressive for someone entering retirement, especially since you do not need to take on that much risk.

A reasonable allocation for a retiree who is willing to take on moderate risk is to have 60% of the portfolio allocated to equity ownership assets (U.S. stocks and foreign stocks, and in some cases real estate and/or other “hard assets” may be included in this mix) and 40% to fixed-income assets (this would be all manner of bonds, including high-yield bonds and foreign debt, as well as the debt of U.S. companies and U.S. governments and mortgages). A recommended breakdown is shown in the asset allocation box accompanying this article.

#### The Cash Portion

Some portion of a portfolio may also be allocated to “cash equivalents” as an asset class. This shouldn’t be confused with creating a short-term liquidity portfolio that’s used for living expenses, emergencies, etc. I would suggest that you adjust your “cash” allocation, currently at \$102,000 (not counting the cash coming from the inheritance) to an amount that would supplement your retirement income for three to five years, so as to allow you to avoid tapping into your long-term portfolio.

For example, your annual expenditures are expected to be roughly \$50,000 a year, plus an additional \$19,000 to cover travel and entertainment to age 70 and medical insurance to age 65—a total of \$69,000. Offset this amount by Social Security, pension and rental income,

**FINANCIAL SUMMARY****Retirement Income Sources (Annual)**

Company Pension	\$12,828
Social Security	21,000
Rental Income	12,000
	<u>\$45,828</u>

**Retirement Spending Requirements**

Estimate of annual ongoing expenses	\$50,000
Additional for travel and entertainment to age 70	8,000
Additional for medical insurance to age 65	11,000
Additional to pay off mortgage	65,000
Additional to cover cost of move	10,000

which currently totals roughly \$45,800, and multiply the remaining \$23,200 by five (assuming five years) and you have a cash allocation of roughly \$116,000. Add to this number any other expenditures you can reasonably anticipate—such as moving costs, the additional amount necessary to pay off the mortgage you'd rather not keep, plus about \$5,000 for emergencies.

Each year, you should reevaluate whether it is a good time to replenish your cash balances or not. If the market has done well, it would be good to rebalance, taking some amounts out from your stock "pot" to replenish the cash "pot." If the market has done poorly, then you could sit tight for another year. This allows you to avoid selling assets in the long-term portfolio at inopportune times.

**Adequate Diversification**

The process of selecting an allocation involves an analysis of the impact of the return potential and volatility on the probabilities of not meeting the minimal target requirements for retirement. Importantly, this analysis assumes that all of the allocations are adequately diversified.

Therefore, the next step in the investment process is to ensure that you have the diversification required to meet the expectations of the "allocation modeling" study. A truly diversified portfolio is somewhat predictable over time. A non-diversified portfolio is not—for example, there is nothing that really can be predicted about a company's value 10 years from now. It could be worth nothing, or it could be tens or even hundreds of times more valuable.

A diversified portfolio such as an index of stocks is predictable in that probabilities can reasonably be assigned to outcomes (knowing, of course, that many of the fundamental pillars we assume will be static could potentially collapse around us—e.g., stability of the U.S. government, soundness of the U.S. dollar, health and "staying power" of the U.S. and world economic

systems).

Until a couple of years ago, research indicated, and most professional advisors believed, that 12 to 20 stocks were enough to eliminate all but an inconsequential amount of individual security risk—risk that is specific to the business or industry of the individual stock or bond issue. More recent studies indicate that as many as 60 stocks in a portfolio are required to eliminate this risk. This is because of the significant increase in stock volatility in recent years. Therefore, arguably each allocated portion of the portfolio needs to have about 60 positions to adequately reflect the systematic risk of the asset class, subclass, style, or market cap being modeled.

The reason you want to eliminate this kind of risk is that you are not compensated for it in the marketplace—in general, you can assume that holding securities that are not part of a well-diversified portfolio has more risk than the return potential justifies. This means that if you were to maintain a portfolio of various styles and market caps, you would need to manage hundreds of different stocks (not to mention how one might deal with a portfolio of individual bonds!). This is clearly unmanageable for most individuals, and I would suggest it is unmanageable for most professional money managers as well.

Right now, you have a significant portion of your portfolio that is invested in only 20 individual stocks. This number of stocks is too low to be adequately

**BALANCE SHEET****December 2002****Liquid Assets**

Cash equivalents	\$102,000
Cash proceeds from estate	\$324,000
<b>Total Liquid Assets</b>	<b>\$426,000</b>

**Non-Tax-Sheltered Investments**

Individual stocks from estate	\$200,000
<b>Total Non-Tax-Sheltered Investments</b>	<b>\$200,000</b>

**Retirement Assets**

Traditional IRAs	\$387,000
Roth IRAs	\$16,000
Fixed annuity (since 1978)	\$17,000
<b>Total Tax-Deferred Assets</b>	<b>\$420,000</b>

**Property**

Real estate rental property	\$410,000
<b>Total Property</b>	<b>\$410,000</b>

<b>Total Assets Available at Retirement</b>	<b>\$1,456,000</b>
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diversified, for the reasons I stated above. In addition, all of the stocks in this portfolio are large-capitalization stocks, giving no exposure to other areas of the stock market.

### Who Will Manage It?

You've indicated that you've had some luck with mutual funds in the past but have no real experience managing individual stocks. However, you now have a very significant portion of your portfolio in individual stocks, as well as a large chunk of cash coming from the sale of real estate.

Every investor needs to decide what the likeliest way is to maximize their return versus risk. Inherent in this decision is the question of how much of the investment process you feel capable of taking on yourself.

If you are of a mind that you can pick stocks as well as a full-time stockpicker (a money manager of either a mutual fund or a separate account), then you qualify for the "do-it-yourself" camp.

If you decide to manage your own stocks, it is important to decide what philosophy and process you'll follow. For example, will you follow a "fundamental" or "technical" strategy? One requires substantial research and monitoring of corporate financials, top management, market share, R&D expenditures, etc.; while the other requires in-depth knowledge of the behavior and history of the markets in general and how to read and interpret individual company stock price behavior. Will you buy based on the company's balance sheet (value investor) or the historical earnings growth and growth potential (growth investor)? Will you be a "top down" or "bottom up" investor?

If you wish to do it yourself, I recommend Harold Evensky's "Wealth Management," Roger Gibson's "Asset Allocation," and Charles D. Ellis's "Investment Policy: How to Win the Loser's Game" as a start. Also, consider the Investment Management Consultants Association study materials for the in-depth and broad-based knowledge necessary for creating a long-term investment portfolio. This will cost you several thousand dollars and many hours of study, but with a million dollar portfolio, I would suggest this as the best single investment you

### PROPOSED ASSET ALLOCATION

<b>Stocks</b>	<b>Taxable Assets</b>	<b>IRA Assets</b>
Large-Cap Value U.S. Stocks	22%	20%
Large-Cap Growth U.S. Stocks	22%	21%
Small-Cap Value U.S. Stocks	2%	2%
Small-Cap Growth U.S. Stocks	2%	2%
International Stocks—Developed	12%	14%
International Stocks—Emerging Markets	0%	1%
	<b>60%</b>	<b>60%</b>

<b>Bonds</b>		
Municipal Bonds	30%	0%
Intermediate Treasuries	0%	16%
Corporate Bonds	0%	16%
High-Yield Bonds	6%	4%
International Bonds	4%	4%
	<b>40%</b>	<b>40%</b>

<b>Portfolio Characteristics</b>	<b>Taxable Assets</b>	<b>IRA Assets</b>	<b>Combined</b>
Expected Return (aftertax)	7.33%	9.48%	8.03%
Annual Volatility (standard deviation)	7.40%	9.80%	8.12%
Yield	3.26%	4.01%	3.48%
Downside (worst-case scenario over a 12-month period)	—	—	–11.6%
<b>Probability of Annual Return Below:</b>	<b>6%</b>	<b>3%</b>	
Through Year 1	38%	23%	
Through Year 9	24%	6%	
Through Year 17	24%	0%	
Through Year 25	15%	0%	
Through Year 33	12%	0%	

could make if you decide to go it alone.

If you do not believe you can do as well as a full-time stockpicker, then a very important step for you is to find someone who is qualified to assist you on a permanent, full-time basis.

One approach would be to hire a money manager who would handle your individual stocks in a separate advisory account. Keep in mind, however, that money managers need to be monitored and evaluated just as individual stocks and bonds do. Stock and bond picking is a talent that involves specific people, and money management firms can lose the very talent that made them good. In addition, the manager typically has a philosophy and approach that may exclude certain segments of the market—for instance, his approach may favor large-cap investing.

Another strategy would be to simply follow an indexing approach—using index funds or exchange-traded funds. Or, if you trust your own mutual fund selection skills, you could add to your existing funds and select

new actively managed funds such that your desired asset allocation is met. The incoming cash from your inheritance would be allocated among these selected mutual funds such that your suggested asset allocation is met. And your individual stock holdings would be sold, with the proceeds allocated to the mutual funds.

But, again, money managers and mutual funds need to be monitored and evaluated also, and once again you need to evaluate your own skills at doing this with the large amount of money you are expecting.

That is why you may want to consider a third approach: Hire a consultant and enjoy your retirement. Many advisors to high net worth individuals such as yourself can create broadly diversified portfolios using separate account managers, mutual funds and/or exchange-traded funds. These advisors also have access to many vehicles that once were available only to large institutional investors. Total costs are now far less than the 3% fees charged by the big brokerage firm "wrap accounts" of years past. Most consultants will charge less than 1% on a \$1 million; a portfolio blend of fixed

income and equity should incur manager fees of about 0.8% in total. That compares to total expenses (excluding transaction costs) of 1.4% for the average equity mutual fund, while the typical "broker sold" equity fund can have a front-end charge of 4% or more.

Independent consultants can be found through the Investment Management Consultants Association (9101 E. Kenyon Ave., Ste. 3000, Denver, CO 80237; 303/770-3377, [www.imca.org](http://www.imca.org)).

Also, CPA personal financial specialists can be found through the American Institute of Certified Public Accountants, or AICPA (1211 Avenue of the Americas, New York, NY 10036; 212/596-6200; [www.aicpa.org](http://www.aicpa.org)).

Look for consultants who will provide investment advice on a fee basis, not commissions, and ask direct questions about their independence, objectivity and sources of compensation. Request a copy of the SEC-required "Form ADV" brochure and read it carefully before engaging any advisor.

*Sincerely,  
Clark Blackman*

## A Benefit of Membership

### AAIL LOCAL CHAPTERS

AAIL's over 50 local chapters bring investment education and insight to your doorstep through our series of unbiased and informative meetings (see the complete chapter list on the inside back cover of this issue).

*The following list covers chapter meeting information for June 10 to July 10. If you see a meeting that interests you, please visit the chapter's Web page at [AAIL.com](http://AAIL.com) or call 800-428-2244 for full meeting details, including fees and registration requirements.*

#### Boston

##### *"The Significance of Transaction Costs in Quantitative Investing"*

Tues., June 17, Doubletree Guest Suites, 550 Winter St., Waltham. Speaker: Daniel Taylor, co-portfolio manager and research analyst, Numeric Investors L.P. Registration/cash bar/social, 6:00 p.m.; dinner, 6:30; program, 7:30.

#### Charlotte

##### *"Why Investment Plans Fail and How to Increase Your Odds of Success"*

Sat., June 14, Piedmont Natural Gas Co., Corporate Office, 1915 Rexford Rd., Charlotte. Speaker: Dennis Stearns,

president, Stearns Financial Services Group. Registration, 9:30 a.m.; program, 10:00; Q&A, 11:30 a.m.–12:00 p.m.

#### Denver

##### *"Bonds and Bond Funds: What to Do Now"*

Tues., June 10, Koelbel Library, 5955 S. Holly at Orchard, Greenwood Village. Speaker: Annette Thau, Ph.D., author. Registration/refreshments/social, 6:30 p.m.; program, 7:00–8:30; Q&A, during and after the program.

#### Piedmont Triad

##### *"21st Century Portfolio Allocation"*

Sat., June 21, Marriott Greensboro/High Point Hotel, Piedmont Triad Int'l Airport, One Marriott Dr., Greensboro. Speakers: Gib McEachran and John Hardy, partners, Compass Financial Partners, LLC. Program, 10:00 a.m.; Q&A, 11:30.

#### Research Triangle—New Location!

##### *"Beyond Fundamentals: Advanced Technical Analysis"*

Sat., June 14, Golden Corral Restaurant, 6129 Glenwood Ave., Raleigh. Speaker: Rick Swope, active trading consultant, Atlanta region, Charles Schwab, Inc. Program, 9:30 a.m.

#### Silicon Valley

##### *"Socially Responsible Investing"*

Sat., June 21, Lookout Restaurant at Sunnyvale Muni Golf Course, 605 Macara Ave., Sunnyvale. Speaker: Carol Malnick, manager, Nelson Capital's Socially Responsible Investment Services. Registration/breakfast/social, 9:30 a.m.; program, 10:00; Q&A, 11:00.

#### South Carolina—New Location!

##### *"Mutual Fund Mistakes and Other Value Line Lore"*

Sat., June 28, Comfort Suites Downtown, 501 Taylor St., Columbia. Speaker: R. Gregg Brewer, manager, mutual funds research, Value Line. Registration/social/coffee, 8:30 a.m.; program, 9:00–11:15.

#### Washington DC Metro

##### *Gala Dinner Meeting 20th Anniversary Celebration!*

##### *"Finding a Stock Winner: First Step Screening"*

Mon., June 16, Key Bridge Marriott Hotel, 1401 Lee Hwy., Rosslyn, Va. Speaker: John M. Bajkowski, vice president, financial analysis, AAIL. Registration/social/refreshments, 6:30 p.m.; dinner/program, 7:00.