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Puzzling times for wealth management

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The global population of wealthy people has been growing despite the international financial crisis that peaked in 2008, according to Merrill Lynch. In the investment firm's annual "World Wealth" report, Merrill reported that the worldwide number of high net-worth individuals has surpassed the pre-crisis level of 2007.

But even for the comfortably wealthy, these are disturbingly uncertain times. Political inertia in Washington, a crisis of confidence in European sovereign debt and political instability in the Middle East have played lead roles in the dramatic volatility of financial markets this year. Are the wealthy retreating from financial assets and holding more cash? Are they aggressively hunting for bargains in the financial markets? How are tax considerations affecting their wealth-preservation strategies?

To gauge how high net worth individuals are reacting to current events, the Daily Business Review invited a half dozen South Florida-based experts in investment management and tax planning. They offered a number of actionable recommendations for coping with what is certain



to be a volatile new year.

Communication, proper portfolio balance can offset fears

Volatility has pervaded financial markets this year. The sudden surges and slumps in the markets have spooked all types of investors — especially those with the most to lose. So wealth management professionals are working overtime to keep clients' emotions from clouding their judgment.

"We do have a lot of anxious clients, particularly those who are depending on their investments for income," said Cathy Pareto, who advises individuals whose net worth ranges from \$500,000 to \$10 million.

"We are definitely investing our time in education and being with clients more frequently, to keep us on the same page," she said, "so they're not tempted to do things they'll later regret."

Volatile valuations have compounded investors' general sense of uncertainty. Triple-digit moves in the Dow Jones industrial average have become commonplace. Gold prices and currency exchange rates have gyrated wildly, too.

"The only thing people are certain of is how uncertain they are in this environment," Adam E. Carlin said.

Many of Carlin's clients are worried about the impact of prolonged weakness in the economy, so he advises them to minimize uncertainty by maximizing the amount of income-producing securities in their investment portfolios.

"We're probably back in a recession. When there's so much uncertainty, you have to create certainty, so what we look for is cash flow, cash flow, cash flow," he said.

Keeping clients focused on their long-term financial plan and portfolio strategy is one way to help them avoid short-sighted responses to market conditions based mainly on emotion. Big declines in the stock market, for example, have led many investors to sell stocks and put their money in bank accounts and short-term U.S. Treasury securities that yield little, if any, interest.

"We're doing a lot more hand-holding. But after going through the tech bubble and the financial crisis, so many of our clients have been attuned to asset allocation," said Richard Gotterer of Westcott. At the core of Westcott's Florida market are individuals with investment portfolios worth \$5 million to \$10 million.

"We haven't had any clients call us up and say, 'Get us into cash,' in a panic. Certainly it's been a challenging environment. The third quarter was the worst since 2008," he said, referring to the global financial panic triggered by the bankruptcy of investment firm Lehman Brothers three years ago. "But this is not 2008."

Gotterer said many of his clients have chosen to remain invested, rather than withdraw from financial markets, to preserve future opportunities for asset appreciation: "I think our clients have learned that if you panic and you move to cash, or you panic and you go to what's considered the risk-free alternative of Treasuries, that you give up the opportunity to rebound."

But politics could change that. Gotterer said the 2012 presidential election could inject more uncertainty into financial markets: "There's going to be a lot of people talking soon about how to position your portfolio for the 2012 election, and who's going to win, and I think that's going to be a very scary thing for a lot of investors."

Avoid risky long-term Treasuries in favor of municipal bonds, blue-chip equities

Many nervous investors have sold stocks at depressed prices and loaded their portfolios with U.S. Treasury securities and other assets that seem safer. But wealth management professionals are advising clients to resist fear and remain risk takers despite recent selling pressure in financial markets.

Investors face a clear risk that interest rates eventually will rise and drive down the value of low-yield Treasury securities, Adam Carlin said.

"Right now money is dumping into longer [term] Treasuries, and while at the moment, it may feel good for some, it's an incredibly risky transaction," Carlin said. He recommends tax-free municipal bonds as a safer alternative for fixed-income investors.

"We are pretty heavily weighted in municipals," Carlin said. "We believe that's still an area that's very attractive, as long as you do the research and understand the fundamentals of each municipality."

Stock in established companies that regularly pay cash dividends to shareholders also may offer a better balance of risk and return. Indeed, downward pressure on the stock prices of such companies can boost their dividend yield, equal to annual dividend payments divided by share price.

"I'm heavily weighting stocks with dividends, your blue chips," Cathy Pareto said. She described the strategy as a hedge against further declines in the stock market: If a dividend-paying stock declines in price, "I want to pick it up on the income side."

The dividend yield on the Standard & Poor's index of 500 publicly traded stocks, or S&P 500, was 2.3 percent in early October, "higher than the yield on the 10-year Treasury," said Richard Gotterer, who runs the Florida operations of Wescott Financial Advisory.

Gotterer likes undervalued domestic stocks, noting that stocks in the S&P 500 have been trading at 10 times their annual earnings, a historically low level suggesting that many of them are bargains. He also likes stocks issued by companies in such emerging markets as Brazil, China and South Korea, where growing economies have enlarged the population of middle-class consumers abroad: "This is a generational change that's occurring."

But Gotterer also advocates investment diversity, saying that a portfolio that is half stocks and half bonds generally will produce better long-term returns than a portfolio dominated by either type of investment. Investors "need to be strategically invested," he said, "so that when you go through these challenging times, you're not trying ... to figure out where you should be."

Gotterer said there is plenty of liquidity to support higher stock prices. He said investors withdrew about \$55 billion from stock mutual funds and put about \$1.5 billion in fixed-income mutual funds during the third quarter. "The rest went into cash, money market funds and mattresses," he said. "So with a little bit of confidence about what's happening in Europe, and a

little bit of confidence about Washington, it's very easy to see a strong pop-back in U.S. domestic markets."

Think globally and consider giving away depreciated properties

Though residential and commercial property values in South Florida have sagged for years, the area's real estate recession may have further to go, a prospect that has kept some wealthy investors out of the market.

South Florida "always will be a place that attracts people and [real estate] will eventually go up. ... Clearly, the values are very, very low," said David Pratt, an attorney and certified public accountant.

But near the peak of frenzied real estate appreciation five years ago, property prices had risen much faster in South Florida than in many other metropolitan markets across the country, so "it's probably going to take that much longer to recover," Pratt said.

Credit rating agency Standard & Poor's reported in October that its Case-Shiller index of home prices in South Florida dropped in August by 4.6 percent from the level of a year earlier.

Commercial property values have been under pressure, too. Marcus & Millichap reported in the third quarter that the median sale price of rental apartment buildings in the Miami area had fallen by 6 percent on a per-unit basis over the preceding 12 months.

The commercial real estate investment brokerage also reported that the median price per square foot of multi-tenant retail buildings in the Miami area had fallen 21 percent since the third quarter of 2010.

Richard Gotterer said his firm doesn't advise on specific property purchases but encourages some clients to allocate part of their portfolios to income-producing real estate investments around the world, not just in the U.S.

"There are 25 countries that have real estate investment trusts to invest in," Gotterer said. Owning a piece of a diversified pool of multi-tenant commercial properties via a REIT investment

"allows our clients to sleep at night because they know they're going to be receiving a certain stream of income."

Emerging markets in Asia, Latin America and other regions have exceptional investment potential because of their increased productivity and relative financial stability, Gotterer said.

"They don't have the same financial tools that we have. They don't have auto loans. They effectively don't use credit cards. ... So they don't have a lot of the excesses," he said.

Some investors in real estate should consider giving property away instead of selling it at deeply discounted prices, said Sheri F. Schultz. She said aging property owners can reduce their families' tax burden by transferring depreciated real estate as a tax-free gift for estate planning purposes.

A temporary exclusion allows owners to transfer up to \$5 million of property as a gift this year and next year without creating tax liability for the recipients.

But time is short. After 2012, Schultz said, federal lawmakers may lower the \$5 million gift-tax exclusion.

Move quickly to ease estate-tax burden on families

The future course of tax policy is hardly clear. Republican Party presidential candidate Herman Cain's so-called "9-9-9" plan, featuring a controversial 9 percent national sales tax, may be just one in a series of unexpected tax proposals that emerge ahead of the 2012 election.

A national outbreak of "class warfare" could lead to reforms that require wealthy taxpayers to pay more, said attorney Christopher Boyett of Holland & Knight.

That is why many of Boyett's clients and other high net-worth individuals are concerned about how much of their fortune they will have to share with the Internal Revenue Service.



"They are not certain about the future for taxes," Boyett said. His clientele has plenty at stake: The private wealth group at Holland & Knight predominately serves families with a net worth of \$50 million to \$75 million.

Given all the uncertainty, Boyett and other wealth management professionals are encouraging eligible clients to take advantage of temporary estate-tax breaks that expire after 2012.

For many rich individuals, transferring ownership of a business or property before the end of 2012 can minimize the tax burden of their families.

This year and next year, for example, an owner can transfer a business valued up to \$5 million to their children without imposing tax liability on them. But federal lawmakers might reduce the size of the \$5 million gift-tax exclusion starting in 2013. It was \$1 million in 2009.

The tax rate on amounts above the \$5 million exclusion is 35 percent this year and next year, but it could go higher in 2013. The federal government cut the tax rate in 2009 from 55 percent to 45 percent.

David Pratt said federal lawmakers have tried for years to limit the use of discounts in determining the value of a private business for estate tax purposes.

"There have been proposals over the last six years ... that attempted to do away with what are commonly known as valuation discounts in the context of family entities," Pratt said.

Fiske & Co.'s Sheri F. Schultz, a partner and director of business valuation services at the CPA firm, said the IRS currently allows two types of valuation discounts in calculating the estate tax on a privately held business.

One is a discount "for lack of marketability," Schultz said, because selling privately held stock usually takes much longer than selling publicly traded stock. "A closely held business, you cannot just sell it in three days. ... Normally it takes about nine months," she said.

Schultz said another valuation discount is for "lack of control," which applies to the transfer of a minority equity stake in a business. But this estate-tax break appears vulnerable to elimination. It could "go away," she said. "That's what Congress is looking to put a stop on."

Despite family's security, many can't bear to quit

Regardless of economic conditions, many wealthy individuals start planning their philanthropic legacy after they have ensured their family's long-term financial security.

"Even with the bad economy, even with the tax laws, they still have this goal to define what their legacy is, and as they get older, they realize they don't have forever," said attorney Christopher Boyett of Holland & Knight. "They're starting to pull the trigger on these family foundations, on getting the kids involved."

The economy hasn't been very charitable to not-for-profit organizations, though. Wealthy individuals who set up tax-exempt family foundations may struggle to cover operating costs, let alone polish their legacy, if the economy sinks into another recession.

"Charities are really suffering immensely," said David Pratt. "I happen to be the chair of the Jewish Community Foundation in South Palm Beach County and Boca Raton, and our annual campaign [contribution total] has gone down from over \$20 million a few years ago to \$13.5 million."

Pratt said some estates left by deceased executives, investors and entrepreneurs have been stretched thin by a growing family of heirs: "The asset base, while it may have grown, has not grown as fast as the family."

While many wealthy individuals look forward to a leisurely retirement focused on philanthropy, others want to keep working. Richard Gotterer, director of Florida operations for Wescott Financial Advisory, said a client recently called off a deal to sell his business after imagining his life without it.

"His life is so invested in the business that he walked away from a significant deal, and it wasn't about the money for him," Gotterer said. "It became a discussion of what he was going to do

next, and it occurred to him at that point that he was going to go from running the business to basically managing money, something that as an entrepreneur he was not familiar with. He was into touching and running his company."

Cathy Pareto, who runs an investment advisory firm in Coral Gables, said estate planning with aging business owners is often wrought with emotion. "I get a lot of resistance because they don't want to face the reality that this might come to an end someday," she said. "There's a lot of emotional aspects that need to be considered ... It's not just about the financials."

Sheri Schultz, who is a partner with her father at public accounting firm Fiske & Company, said more people are working into their late 60s and beyond because they are healthy enough to do so: "They are not retiring at 65 ... That's another reason they're not willing to just sell and leave their business."

Whether retired or still working, wealthy contributors to charities may face less favorable tax treatment in the future.

Taxpayers who itemize deductions on tax returns can deduct 100 percent of their charitable contributions. But Schultz said this deduction is in danger of being reduced, so wealthy individuals should consider accelerating their charitable giving: "That's something that Obama is looking to cut, so now is the time ... to accelerate deductions."