2015 4th Quarter

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PERFORMANCE WEIGHTED ASSET ALLOCATION REPORT

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ADVISORS' THOUGHTS

2015 was a volatile year for investments with most stock and bond indices we follow showing negative returns. However, in the **fourth quarter** of last year the **volatility benefited your accounts** as the stock market recovered strongly from a weak third quarter. We **continue to emphasize** that a **diversified portfolio** has helped protect your accounts from being concentrated in the worst performing areas while providing a more consistent return during the markets ups and downs.

A look at the Benchmark Return Table shows that once again the **S&P 500 large company stocks** outperformed most other areas of the stock market in 2015 with only a **0.73% decline in index value**. This far **outpaced** the **Russell 2000 small cap stocks** that **declined 5.71%**. Throughout 2015 the market favored a limited number of larger company stocks that disproportionately influenced index returns.

The slightly **negative tilt in the** broad based **US stock market averages** last year was still **better than** many **overseas measures of stock performance.** The MSCI EAFE, representing developed foreign markets, declined 3.3% while the MSCI Emerging Markets index dropped significantly more, down 16.95%. Slower global growth prospects from China and other oil dependent nations weighed heavily on these developing economies.

Perhaps even more revealing were the challenges in the bond market. In 2015 there was a strong

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BENCHMARK RETURNS THROUGH 12/31/15

	3 Mo.	6 Mo.	12 Mo.
DJIA	7.00%	-1.10%	-2.23%
S&P 500	6.45%	-0.93%	-0.73%
Russell 2000	3.20%	-9.42%	-5.71%
MSCI EAFE	4.37%	-6.85%	-3.30%
MSCI Emerging Markets	0.27%	-18.31%	-16.95%
Barclays Inter-term Bond	-0.88%	2.99%	4.04%
Barclays Long-term Bond	-1.83%	3.72%	-0.68%
ML High Yield Bond	-2.09%	-6.87%	-4.55%

Source: Wall Street Journal and Morningstar Principia
Does not include reinvestment of dividends

DJIA: A price weighted average of 30 stocks.

S & P 500: A market value weighted index of 500 stocks.

Russell 2000: A market value weighted index of 2000 stocks.

MSCI EAFE: A stock market index designed to measure the equity market performance of developed markets outside US and Canada.

MSCI Emerging Markets: A stock market which captures large and mid cap representation across 21 Emerging Market countries..

Barclays Capital Treasury Intermediate-Term Bond Index: An index comprised of US Treasury securities with maturities between 2 and 10 years.

Barclays Capital Treasury Long-Term Bond Index: An index comprised of US Treasury securities with maturities of 10 years or longer.

ML High Yield Bond: An index of non-investment grade corporate bonds.

The setting up of an **A-B Living Trust** has **probably** been the **most recommended estate planning technique to reduce estate taxes** as long as Jim Sr. has been in the investment business (50 years as of January 1, 2016). **However, today the A-B** type of **Living Trust**, which most of our married clients have, **may do more harm than good. Remember the concept** was that by splitting **the estate assets into two trusts** at the first estate one could **take advantage of both spouses' Federal tax credit**. This would **lower the overall size of the taxable estate** at the second death. The reason was simple math.

Year	Estate Tax Exemption	Maximum Estate Tax Rate
1942-76	$60,000.00	77%
1977	$120,000.00	70%
1978	$134,000.00	70%
1979	$147,000.00	70%
1980	$161,000.00	70%
1981	$175,000.00	70%
1982	$225,000.00	65%
1983	$275,000.00	60%
1984	$325,000.00	55%
1985	$400,000.00	55%
1986	$500,000.00	55%
1987-97	$600,000.00	55%
1998	$625,000.00	55%
1999	$650,000.00	55%
2000-01	$675,000.00	55%
2002	$1,000,000.00	50%
2003	$1,000,000.00	49%
2004	$1,500,000.00	48%
2005	$1,500,000.00	47%
2006	$2,000,000.00	46%
2007-08	$2,000,000.00	45%
2009	$3,500,000.00	45%
2010	$5,000,000.00	35%
2011	$5,000,000.00	35%
2012	$5,120,000.00	35%
2013	$5,250,000.00	40%
2014	$5,340,000.00	40%
2015	$5,430,000.00	40%
2016	$5,450,000.00	40%

Source: www.taxfoundation.org

From 1942 through 1976 the amount that you could pass to heirs without estate tax was only $60,000 and the maximum tax rate was 77%. On a $400,000 estate in 1966 the estate tax using the maximum rate would have been $261,800, leaving a net estate of just $138,200 to the heirs. By having **two trusts established at the first estate** and putting $60,000 in the B, or Bypass Trust that was not taxed in the second estate, **one would have saved** $46,200 in estate taxes, leaving the heirs $184,400. By 1982 the credit was $225,000 which passed $450,000 to the heirs **by using the A-B type of living trust.**

In 2006 the exemption was $2,000,000, therefore $4,000,000 could pass with an A-B trust without estate tax.

In 2010 the **exemption** went to $5,000,000, and **now is $5,450,000. Today a married couple can leave $10,900,000** to their heirs **with no federal estate tax.** The excess value will be taxed at 40%.

Many people will not pay estate taxes today but unfortunately their current living trusts might still require that the surviving spouse create a second trust.

SO WHAT IS THE PROBLEM?

Over the years we have recommended to many clients that they have their living trust drafted to create the second trust at the first estate to minimize (or eliminate) estate taxes. We have also been involved with the investments of the B trust (Bypass trust to avoid estate taxes at the second estate) and have been well aware of its limitations, including potentially higher income and capital gains taxes. Following are some of the **issues** to consider **in establishing a B trust:**

ISSUE #1

One issue has been the need to file **two tax returns** which increases the cost each year for tax preparation. Depending on the assets in the two trusts, **tax preparation costs may double.**

ISSUE #2

A second issue was the need to re-title the assets going into the B trust. Often times we would meet **people who never re-titled assets** into the B trust creating numerous **legal and tax problems.**

ISSUE #3

A third issue was deciding which **assets should go into the B trust** and which to keep in the A trust (the Survivor's Trust). Decisions regarding the placement of assets could have **major ramifications on income, capital gains and estate taxes.** An **incorrect allocation** as a result of poor planning or unintentionally due to a lack of knowledge, could cause a number of **problems for the surviving spouse and heirs**.

ISSUE #4

A fourth issue occurs around the handling of trust income. **Trust tax brackets** reach the **maximum tax rate at very low levels of income** compared to individual tax rates. If the plan was to payout income to the surviving spouse then this may not be a problem. However, sometimes the surviving spouse didn't need the income and it merely was increasing their taxable estate. In addition, the heirs may have benefitted from the income and been in a lower tax bracket, but unless drafted properly the B trust may not have been able to make those distributions.

ISSUE #5

A fifth issue occurs when the heirs inherit the assets from the B trust. **Assets in the B trust do not receive a step-up in tax basis.** Therefore, any gain in value on the assets held in the B trust from the first estate is subject to capital gains taxes when sold. Assets inherited at the second estate from the A trust (Survivor's Trust) receive a step-up in tax basis and therefore if sold at the value of the second estate avoided capital gains tax. The lack of a step up in basis on the B trust is a major issue to consider.

WE WORKED AROUND THESE PROBLEMS

We've always worked with these issues of the A-B trust concept. The goal was the elimination of the 40% to 70% estate tax. **For many** of our clients the **negative issues of the A-B trust** were **outweighed by the positives**, but **may not be anymore**.

The **American Taxpayer Relief** Act of 2012 has **now made permanent** a number of important tax code provisions that we feel will **impact estate planning for years to come**. The **higher estate tax exemption** reduces how many people will be paying the estate tax.

The **ability** of the **surviving spouse to use both spouses' exemptions at the second death** allows an estate to **pass up to $10,900,000 in 2016** to heirs **with no estate taxes**. The Bypass Trust has become largely irrelevant. In fact, Bypass Trusts can actually become an adverse strategy for many.

FUTURE NEED FOR SECOND TRUST

There **may still be reasons for a second trust** but it may not be structured as a Bypass Trust, but rather a "C" or Marital Trust. A second trust may still be useful in sheltering future growth in regards to the generation skipping transfer tax exemption, as well as some income tax planning.

The **use of trusts** in general will **remain relevant for many non-tax reasons especially** around **creditor protection** and **family wealth management**. Issues of divorce, lawsuits or spendthrift protection are very important considerations in planning. Nevertheless, it appears to us that with the new rules, especially the ability to use all of both parties' exemptions, it **may be time to bypass the Bypass trust** for the overwhelming majority of the people we work with.

CURRENT BYPASS TRUST

For those of you that have a B trust there are some things you might consider doing to eliminate some or all of the five issues outlined above. We will discuss these with you individually.

TIME TO REVIEW

We are dedicating **2016** as the **year for an estate plan review**. We feel most everyone needs to update their living trusts so as to eliminate the potential five problems of having the Bypass Trust. We will be contacting you to review all the details that need consideration for change.

GOOD BYE BYPASS!
HELLO SIMPLIFICATION!

We never thought it would come to this but luckily it has. During this year **we will be scheduling appointments with each of you** to review the above. If you have other changes you have been considering, feel free to give us a call and we will schedule your appointment.

flight to credit quality, with the Barclays Intermediate Treasury index gaining 4.04%. This occurred during a time when many believe that interest rates will be rising and the 10 year Treasury yield has been hovering just above 2%. In fact, as a sign of growing confidence about the US economy, the Federal Reserve on December 16th increased the federal funds rate 0.25% up to a range of 0.25% to 0.50%.

Meanwhile, the **Merrill Lynch High Yield index** returned a **negative 4.55%**. This measurement of non-investment grade bonds is **telling us** that there is **concern over** the ability of some **weaker companies to meet their debt obligations**. **One of the largest sectors** within this index is energy (oil, natural gas etc.) and the price of these commodities have been **falling significantly in recent weeks.**

Weakness overseas has led to a concern in the US that our economic expansion is about to end, however some current economic data is suggesting otherwise. With the negative headwind of the energy sector it may take some time before corporate earnings reflect the true reality of the US economy.

The **Conference Board Leading Economic Index (LEI) increased 0.4% in November** following a 0.6% gain in October and no change in September. In its press release it stated, "Although the six-month **growth rate of the LEI has moderated**, the economic **outlook** for the final quarter of the year and **into the new year remains positive.**"

In addition, **other signs of strength** remain intact. The US job market continues to expand with the Labor Department reporting **nonfarm payrolls increasing 292,000 in December**, and were up an average of 284,000 a month in the fourth quarter of 2015. Furthermore, applications for weekly jobless claims remain low and are consistent with a healthy job market.

US auto sales set a record in 2015 with 17,402,659 light-vehicle sales last year, an increase of 5.7% over 2014 according to the Automotive News Data Center. It appears that a solid job market along with many people delaying a new vehicle purchase (after the last recession) has led to a strong performance in the auto industry. In particular, trucks, SUVs and crossovers continued to lead the growth in sales with an increase of 13% in 2015. This is in contrast to a modest decline in car sales of 2.3% in 2015. Lower oil prices, have led to lower gas prices nationwide and this we believe is adding to the consumer preference to purchase trucks, SUVs and crossovers instead of cars. Overall the **auto industry is benefitting from lower oil (gas) prices**.

The significant **decline in oil** has **led to a sharp drop in corporate earnings in the energy sector.** At the start of earnings season, S&P Capital IQ states in its report, "Lookout Report from Global Market Intelligence" dated January 8, 2016 that it is expecting earnings growth to decline 68.6% year over year in the energy sector. This whopping decline is leading to an anticipated decline in the overall S&P 500 earnings. However, **if energy was excluded the S&P 500 earnings would be up a modest 0.4%.** The negative impact on earnings from oil are being felt today, but the **positive benefit of lower gasoline prices have yet to be felt**. Earnings for many companies should benefit as consumers have more to spend from their savings on gasoline.

As we **move into 2016,** a heightened **concern over global** growth prospects has **led to declining stock markets** around the world. A slowing economy in China, the world's second largest economy, has put downward pressure on economic prospects and helped exacerbate the declining price of oil. This despite the fact that here **in the US current economic data** is still **pointing to an expanding US economy.** In the meantime, **diversification** in your accounts is **helping cushion the current negative impact** from the financial markets.

While **we remain positive** about the **long term** outlook, we are actively monitoring economic and market conditions and **prepared to make adjustments to your investment allocation as needed.**