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# THE WORTH GUIDE TO FINANCIAL WELLNESS

## TRYING TO RECOVER FROM THE DAMAGE THE RECESSION INFLICTED ON YOUR WEALTH? AS WE LOOK FORWARD TO 2010, CONSIDER THESE 10 STEPS BACK TO FINANCIAL HEALTH.

To say that it's been a slog lately for high net worth investors is something of an understatement. In 2008 alone, the financial crisis vaporized more than \$12 trillion in global wealth, according to the Boston Consulting Group. In North America, high net worth households suffered a 22 percent decline in aggregate wealth as nearly every asset class notched losses, versus just six percent in Europe and Asia. This year equity markets are on the mend, but it's a slow process: BCG figures that millionaire households' personal balance sheets won't rebound to pre-crisis levels until 2013. This dramatic destruction

of capital raises the stakes for year-end financial planning. "Good estate planning and good tax planning will by far have more impact than good investment planning," argues Steven Lockshin, founder and CEO of Washington, D.C.-based Convergent Wealth Advisors, which provides all three services to ultra-high net worth families. The pace and sustainability of the market's recovery are big unknowns. But there are still plenty of steps you can take to maximize your wealth. With interest rates at historic lows, for example, it's far easier to transfer assets to future generations tax-efficiently. And managing

your tax burden has never been more important: With a president who is likely to raise taxes on households earning more than \$250,000 a year and a federal budget deficit projected to top \$1.4 trillion—the highest as a share of the U.S. economy since 1945—Uncle Sam will undoubtedly be reaching even deeper into your pocket in the coming years. In this challenging environment, managing wealth isn't easy. As the year comes to a close, here are 10 planning ideas to discuss with your financial advisor that should help you prepare for the year ahead.

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"DO YOU HAVE A PLAN TO SAFELY RESTORE THE VALUE YOU LOST?"

## 1 HEDGE AGAINST HIGHER TAXES

WHEN IT COMES TO REDUCING YOUR TAXES, THE STANDARD ADVICE IS TO DEFER INCOME INTO FUTURE YEARS AND ACCELERATE EXPENSES. But this logic only applies when tax rates are stable or falling. Even if Congress does nothing to impose new taxes, the Bush administration tax cuts will expire at the end of 2010, pushing the top income tax bracket and the top rate on dividends to 39.6 percent, up from 35 percent and 15 percent respectively. The top capital gains rate will climb from 15 percent to 20 percent.

"The odds of us seeing a 35 percent tax bracket again in our lifetimes are remote," says Herb Daroff, an estate planning specialist with Baystate Financial Services in Boston. As a result, "it's a very different end of year tax-planning year than I've ever seen."

Daroff's advice: **Accelerate any additional income from bonuses, incentive pay, stock options or consulting work into this tax year, since the tax bite is likely to be bigger in future years.** In addition, he suggests postponing the recognition of expenses that reduce taxable income into future years, when potentially higher rates could make the deductions more valuable. And business owners who can control the timing of dividend income should consider accelerating payments into this year, while it's taxed at 15 percent. "It's the complete opposite of the conventional wisdom," Daroff says.

## 2 CONSIDER A ROTH CONVERSION

IN 2010, THE IRS WILL ELIMINATE THE ADJUSTED GROSS INCOME CAP OF \$100,000 THAT PREVENTS MANY HIGH-INCOME INVESTORS FROM CONVERTING A TRADITIONAL IRA TO A ROTH IRA. Converting seems like a no-brainer since Roth IRAs enable you to withdraw assets tax-free and do not mandate any minimum distributions, thus enabling you to preserve tax-free growth for retirement assets that you don't currently need. Still, Roth conversions require careful analysis. "Conceptually, it's a great thing," says financial advisor Ross Levin, founder of Accredited Investors in Edina, Minn. "But for high net worth people, it's tricky."

Here's why: When you convert to a Roth IRA, the amount that you transfer is treated as taxable income. To figure out whether it's advantageous to convert, you must make some assump-

tions about the future growth of the assets in the account and your future tax rate, among other factors. If paying the tax now doesn't set you up to earn even more over your time horizon on an after-tax basis, conversion isn't worth it. Most important, advisors say, you must have funds available outside of your retirement accounts to pay the tax or the economics typically won't make sense. "It's the absolute death knell of a Roth conversion if you have to take money out of the IRA to pay the tax," says Baystate's Daroff.

Under IRS rules, if you convert in 2010, you can spread the tax burden over the 2011 and 2012 tax years. But with the top tax rate likely to climb higher, that could prove treacherous. Daroff's recommendation: **If you don't have to wait until next year to convert to a Roth IRA, complete the conversion in 2009.** People with variable income and ample deductions from investment losses just might slip under the income cap anyway.

## 3 PROTECT YOUR ASSETS FROM CREDITORS

HERE'S A SCENARIO THAT WILL KEEP ANY PARENT AWAKE AT NIGHT: Junior borrows your sports car, collides with another vehicle and gravely injures its driver, a surgeon, who can no longer perform in the operating room. Robbed of his income, he sues you and your son—and wins a multimillion-dollar jury verdict. Your savings, future earnings and even your homes are at risk.

**One way to protect yourself is to buy an umbrella insurance policy, which can add millions of dollars in liability protection to the policies that you already carry on your home, car or boat.** The coverage isn't expensive: Insurance company USAA sells policies offering \$1 million in protection for \$228 a year.

If you work in law, medicine or another litigation-prone field, consider going one step further by setting up an asset protection trust to shield your wealth from plaintiffs and creditors. Prior to 1997, not a single U.S. state permitted these instruments, which enable trust creators, called grantors, to be the beneficiary of their own trust. But today, regardless of where you reside, you can set up an asset protection trust in one of the 11 states that now permit them: Alaska, Delaware, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah or Wyoming.

"If you set one up before you ever get sued, creditors can't reach the trust," says estate planning attorney Daniel Rubin, a partner at Moses & Singer in New York. "I encourage clients to do the planning ahead of time."

## 4 INSURE YOUR PORTFOLIO

IF YOUR FAMILY DEPENDS ON YOUR INCOME FOR LIVING EXPENSES, YOU NEED LIFE INSURANCE TO REPLACE THAT MONEY IF SOMETHING WERE TO HAPPEN TO YOU. But after last year's market rout, you just might need the same kind of replacement insurance for your portfolio. Heavily tilting your investments toward high-risk assets isn't a viable strategy. "The question I ask clients is, 'Do you have a plan to safely restore the value you lost?'" says financial advisor Daroff.

He took his own advice to heart last December when, after seeing his portfolio shrink in size, he became concerned about the diminished value of the assets available to his wife and kids if he were to die before the investments recovered. **To lock in a replacement value, Daroff bought a 10-year term life insurance policy for an amount equivalent to his losses.** "If it takes less than 10 years for my portfolio to recover, I'll get rid of the insurance," he explains. "But if I die today I know that my wife and kids would have the same portfolio value that I would have had if the stock market hadn't collapsed."

Term insurance is cheap. For a healthy, non-smoking 40-year-old man, a 10-year guaranteed level term life insurance policy from MetLife costs just \$334 a year for a \$500,000 benefit. Portfolio insurance offers another potential reward: The peace of mind it provides just might keep you from taking excessive risks to earn back losses. "It not only makes up for what you lost," says Daroff, "it gets your expectations back on track."

## 5 TRANSFER YOUR WEALTH TAX-EFFICIENTLY

THERE HAVE BEEN VERY FEW SILVER LININGS TO THE LINGERING FINANCIAL CRISIS. But an obscure

interest rate set by the IRS, called the Applicable Federal Rate, fits the bill. The AFR is a hurdle rate of sorts for individuals looking to transfer assets to beneficiaries during their lifetimes while retaining an income stream during the trust term. **If the return on the trust assets beats the AFR, all the appreciation above that rate passes to beneficiaries free of gift tax.**

The AFR has nudged upward in recent months, but it's still near historic lows—just 3.2 percent as recently as October. That strengthens the case for setting up a grantor retained annuity trust, or GRAT. "We're telling clients that if they plan to do one, they should do it now," says Robert Gordon, president of Twenty-First Securities, a New York brokerage firm.

There's another good reason to act quickly. Many estate planning attorneys prefer to set up so-called "zeroed-out" GRATs, in which grantors receive annuity payments equivalent to the value of the assets that they transferred into the trust plus interest. By taking all of their principal back over the term of the trust, they can ensure that no gift tax will be due. Since a grantor must remain alive during the trust term to avoid having the assets revert to his or her taxable estate, zeroed-out GRATs are typically established for a period of just two years. But this level of certainty could disappear: As part of its tax overhaul, the Obama administration has proposed lengthening the minimum term of a GRAT to 10 years. Before that happens, Gordon explains, "there's a window here to take advantage of the shorter minimum and the lower interest rate."

## 6 PROTECT YOUR HEIRS (FROM THEMSELVES)

IF YOU'RE A PARENT, YOU WANT THE WEALTH THAT YOU BEQUEATH TO YOUR KIDS TO BE A POSITIVE FORCE IN THEIR LIVES. But if you gift assets directly to them, you surrender the certainty that the money remains in their possession. Some kids, regardless of age, just aren't

equipped to manage large sums of money. Others may enter high-risk professions like medicine and expose themselves to litigation. And if there's a messy divorce, all bets are off: The estate you intended to leave to your children and grandchildren could end up lining the pockets of an ex-spouse.

The solution is to set up an irrevocable "family protection" trust, which can be created during your lifetime or spelled out in your will and funded when you die. **By leaving assets to the trust, rather than making direct gifts to beneficiaries, the money will be shielded from lawsuits, creditors and ex-spouses alike.** "You can't protect your children from making bad decisions," says Moses & Singer's Daniel Rubin. "But you can protect them from these outside forces."

You should also provide your heirs with the right gatekeeper. Rather than naming a family trustee to manage the trust and approve distributions to beneficiaries, says Bernard Krooks, a founding partner at Littman Krooks in New York, stick with a corporate trustee—a bank or investment firm "that has investment experience, knows trust law and can file the tax return."

Your heirs should have some responsibility too. Estate planners suggest including a provision that enables them to replace the trustee once they reach a certain age (35, say). You might also name your heirs as

co-trustees so that they get involved in the management of the assets and develop an appreciation for financial stewardship. Says Carol Warnick, an attorney with Holland & Hart in Denver: "Too many wealthy parents allow their kids to inherit large sums of money with virtually no training as to how to manage it responsibly."

## 7 RESTRUCTURE YOUR BALANCE SHEET

ACCORDING TO THE NATIONAL BANKRUPTCY RESEARCH CENTER, A BURLINGAME, CALIF.-BASED RESEARCH FIRM, Chapter 11 bankruptcy filings by wealthy individuals jumped 73 percent in the second quarter compared to the same period a year ago. One who borrowed heavily against stock or real estate that has declined substantially in value is at risk. "We're seeing people whose liabilities remain very high but whose assets have gone kaput," says S. Alexander Haverstick, managing partner of Boxwood Strategic Advisors, an advisory firm in New York that helps wealthy families navigate liquidity crises.

Credit problems can be paralyzing. But **if you are facing a crunch, negotiating a workout plan should be at the top of your to-do list.** Lenders are under pressure to clean up their balance sheets and may be willing to cut a deal.

"Banks want to get this stuff cleaned up before year's end," says Haverstick.

His advice is to be transparent and cooperative. As a show of good faith, consider providing your lender with a complete financial picture. The disclosure will help you make the case for how you'll pay back the loan. In some cases, the workout plan may call for collateral substitution. Often the plan will require a sale of assets. That's why an overleveraged borrower's objective is twofold: First, get the bank to agree to a partial payment of the loan to minimize asset sales, says Haverstick, and second, secure an agreement from the lender to restructure your remaining debt using other collateral.

## 8 CONSIDER LIQUID ALTERNATIVE INVESTMENTS

ROSS LEVIN MAY HAVE FOUNDED A FINANCIAL PLANNING FIRM CALLED ACCREDITED INVESTORS, but he has never been much enamored with pricey and opaque alternative investments like hedge funds that are

typically only available to well-heeled "accredited" investors. "We couldn't get over the two and 20 hurdle," says Levin, referring to the industry standard two percent management fee and 20 percent incentive fee.

These days, though, **Levin has joined a growing number of financial advisors who have discovered that they can access low-volatility hedging strategies for clients at a fraction of the price by using mutual funds.** "You get hedge fund strategies in a vehicle that is regulated, liquid, transparent and lower cost," explains Rick Lake, co-founder of Lake Partners, an investment advisory firm that follows these funds closely. He says the strategies run the gamut but can be divided into four main categories: hedged equity funds; long/short bond funds; futures, commodities and foreign exchange funds; and multistrategy funds.

One standout, Lake says, is Robeco Boston Partners Long/Short Equity Fund (ticker: BPLEX), which was launched in 1998 and boasts one of the longest track records in its category. Late last year, the fund began buying high-quality small-cap companies whose depressed stock prices had pushed them into micro-cap territory. The bet paid off and the fund was up 77 percent this year through September 30. On the fixed-income side, Lake favors the Driehaus Active Income Fund (LCMAX), which was up 16 percent over the same period and has delivered steady returns with low volatility since its 2005 launch.

If you'd like to add a low-cost hedge to your portfolio but are daunted by the options, consider diversified exposure: Earlier this year, Lake Partners began sub-advising the Aston/Lake Partners LASSO Alternatives Fund (ALSOX), which holds a basket of hedged mutual funds. It's up 12 percent since its inception in April. "If someone wants a turnkey strategy," says Lake, "it's an easy way to go."

## 9 CONSIDER A "DO IT YOURSELF" STRUCTURED NOTE

IF YOU HAVE BEEN LOOKING FOR A WAY TO GENTLY WADE BACK INTO THE MARKET WITHOUT RISKING THE KINDS OF LOSSES THAT RAVAGED PORTFOLIOS LAST YEAR, you might be tempted to invest in a structured product—prepackaged investments that combine a standard investment in a stock, commodity or index with options or derivatives, a combination that is usually designed to provide a degree of principal protection. "It's a way for things to be a little less scary," says Twenty-First Securities' Robert Gordon. "They provide a seat belt."

The trouble with structured products, however, is that the fees are opaque and the products are only as good as the counterparty that underwrites them. If that counterparty goes bust—like Lehman Brothers, one of the largest issuers of structured products in the U.S.—you're out of luck. That's why **Gordon and his firm are doing a brisk business helping investors replicate structured products using exchange-traded options, an approach that eliminates counterparty risk.**

Twenty-First Securities also develops far more complex structured products for clients using a multitude of underlying investments, including, most recently, a mid-cap equity index and a natural gas exchange-traded fund. For investors seeking a safer, more transparent way to hedge market exposure or place a concentrated bet, they're a smart way to go. "When you replicate, it's more direct," says Gordon. "It lays bare exactly what you're getting."

## 10 GO COMMERCIAL

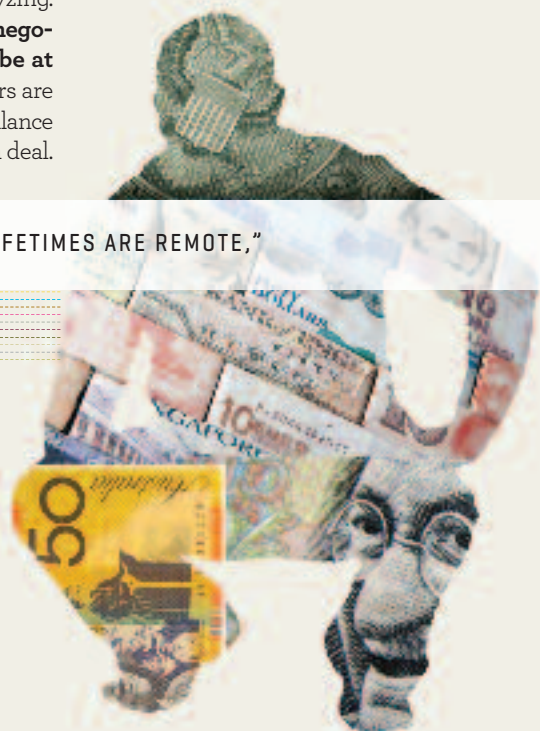
RENOWNED MONEY MANAGER SIR JOHN TEMPLETON FAMOUSLY URGED INVESTORS TO "BUY AT THE POINT OF MAXIMUM PESSIMISM." In today's market environment, nothing fits the bill better than commercial real estate, where pessimism has tipped into despair—and created opportunities for patient investors with capital to deploy. "There is going to be a large transfer of wealth between people who own and have overleveraged commercial real estate but can't refinance, and the people who have liquidity," says Convergent Wealth's Lockshin.

The statistics are a case study in distress. With financing "still difficult to obtain" and closings "arduous," according to commercial property broker Jones Lang LaSalle, transaction volume in the Americas totaled just \$17.2 billion in the first half of 2009, down 77 percent from the same period last year. According to research firm Preqin, private equity real estate funds raised just \$4.9 billion in the third quarter, down from \$40 billion in the same period a year ago. "There's a shortage of capital," says John Workman, Convergent's Portland, Ore.-based chief investment strategist. "So capital put to work there should be rewarded nicely."

Workman says **Convergent views still-depressed commercial real estate as a savvy alternative to stocks, which no longer look cheap. He expects A-grade office space in prime locations to deliver attractive, equity-like returns of eight to nine percent annually.** ☺

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