



# GOING LONG

## Detterbeck Wealth Management, Inc.



MAY 2006

### Hey, What's My Benchmark?

By Les Detterbeck, CPA, MBA, CFP®, PFS, CFA



After the quarterly investment reports get mailed to all of our clients, we usually get a phone call or two. Sometimes the question is, "what is the right benchmark to measure the performance of my (our) portfolio?" It's a good question. Here's our answer.

As you know, the benchmark should be a gauge or yardstick used to compare performance in your portfolio to a standard. The standard will vary between investors since it should reflect the asset allocation of your unique portfolio. Since we tailor each investor's asset allocation to their specific objectives and constraints, each investor theoretically would have their own benchmark.

If your entire investment portfolio was invested only in large capitalization United States equities, your benchmark might be the S&P 500 Index or the Dow Jones Industrial Average. If your equities also included small and mid cap companies, you might use the Russell 3000 which covers the US Total Stock Market. If half the portfolio was only large caps and the other half was allocated to the total stock market, you could use a blended benchmark; for example 50% S&P and 50% Russell 3000. And, of course, if your equities include foreign stocks and emerging markets, there are other benchmarks that could be factored in as well.

When it comes to bonds, there are indices for high yield bonds, government bonds, municipal bonds, global bonds and the total bond market. Again, the benchmark to use if the entire portfolio was an assortment of all different types of bonds would be to either use the total bond market index or some

blend of a number of indices.

Some investments don't easily lend themselves to being benchmarks. Indices for alternative assets generally are not readily available. The primary reason is that many of these assets are illiquid. They don't trade on the open market each day. The returns are typically made up of a regular monthly or quarterly distribution and then, oftentimes, a return of principal plus or minus a premium or discount at a later date a few or some years down the road.

So, with all of this information and every client with a unique asset allocation and a unique rate of return expectation, what's a good rule of thumb? We suggest that most of our clients use a "Balanced Portfolio Benchmark" as a starting point. We do that with a blended rate using 50% Russell 3000 and 50% Lehman Brothers Aggregate Bond Index. This would reflect a portfolio made up of roughly 50% diversified equities and 50% diversified bonds. The table below details the rate of return for the Russell 3000, Lehman Brothers Agg. and this blended index for the periods shown:

Index	3 Mos. Ending 3/31/06	2005*	2000 - 2005*	2002 - 2005*
Russell 3000	5.31	6.14	15.90	1.58
Lehman Bros. Agg. Bond	-.65	2.43	3.62	5.87
Blended Benchmark (50/50)	2.33	4.29	9.76	3.72

\*Rate of returns for periods greater than a year are annualized

Our clients with a balanced portfolio, that is, a portfolio made up of stocks, bonds and alternatives should have returns that can be compared to this benchmark. Clients that have primarily stocks or

### PRIVATE ANNUITY TRUST STRATEGY DEFERS INCOME TAXES AND PROVIDES DIVERSIFICATION AND LIQUIDITY

By Les Detterbeck, CPA, MBA, CFP®, PFS, CFA

We all like to see our assets appreciate. And none of us likes to pay taxes. So, what do you do if you have highly appreciated real estate or stock in a business that you would like to sell, but you don't want to pay taxes?

Consider a private annuity trust ("PAT") which can provide liquidity and diversification now and postpone the taxes to the future. In certain circumstances, this could work better than a 1031 Exchange.

First, let's talk about 1031 exchanges. Most people know that a 1031 "tax-free" exchange allows taxpayers to exchange one piece of qualifying real estate for another and not pay current tax. While a 1031 may be an appropriate strategy for some, here are two potential problems with 1031 exchanges:

1. Many taxpayers want to reduce their investments in real

estate, not just exchange one for another. They would rather diversify and put their proceeds into marketable securities rather than illiquid and perhaps overvalued real estate.

2. There may not be a good reinvestment property available. Yes, there are programs that offer "tenant-in-common" 1031 reinvestment properties. But, many feel that the 1031 market is saturated and there are not good economic purchases available.

So, now, many investors are looking at PATs as an option for selling their real estate and business ownerships.


Here's how it works. Mr. Jones (or Mrs. Jones) transfers his property (real estate or shares of stock) to the PAT before the sale is complete. The PAT will issue a private annuity back to Mr. Jones. This is not an insurance contract and it is not a gift. The private annuity is a contract whereby the annuitant (Mr. Jones) transfers property to the other party (the PAT) in ex-

*(Benchmark continued from page 1)*

primarily bonds should be more closely compared to the appropriate index.

It is also important when reviewing quarterly results and comparing to benchmark(s) to compare the results to client return expectations. In particular, after we discuss our clients' objectives and risk tolerance we help them develop scenarios ("road maps") for the future. These include investment rates of return. The asset allocation is designed to meet the investment rate of return required in the scenario without incurring any more risk than is needed. Hence, if a 6% return is assumed in the scenario, then the asset allocation is developed with that in mind.

Therefore, while it is interesting to compare actual performance to benchmarks, the more important target is to meet the long-term investment return expectations.

In future quarterly reports, we will be including a "balanced portfolio benchmark" as one of the indices. We think it can be helpful. And, as you know, we always welcome the opportunity to discuss your portfolio, your performance and most importantly, help you to turn your financial vision into reality. 

*(PATs continued from page 1)*

change for a promise to make periodic payments for a fixed period of time or for life.


Then, the PAT sells the property. The Trust does not pay a gain on the sale of the property since the annuity payments in the future were based upon the fair market value of the property. No tax is due on sale. The proceeds can be invested as the Trust wishes.

The PAT starts paying Mr. Jones at the agreed upon date. Mr. Jones can defer the annuity stream until age 70 1/2 to allow the proceeds to grow. The annuity stream is taxed each year as payments are made. Part of the payments, equal to the tax basis, will come back tax-free. The capital gain on the sale will be taxed over the term on the payments. The remainder of the annuity payments will be taxed at ordinary income. So, for example, a \$2 Million gain that might have resulted in \$400,000 of taxes without a PAT will now have the \$400,000 in taxes paid over 20 years for example and no payment for taxes will be made until the annuity payments start.

Finally, if Mrs. Jones dies after the payment term and there is still money in the PAT, those assets will pass to the heirs free of income and estate taxes. This can happen if the trust generates higher returns than are needed to pay out the annuity stream for the stated period.

In conclusion, the PAT allowed Mr. Jones to:

- Sell his real estate (or business) with no current taxation
- Diversify his assets into whatever investments he wanted
- Grow the assets in the PAT with minimal income tax until annuity payments start
- Determine and be able to count on a regular cash flow during retirement coming from the PAT
- Pay the capital gain tax over many years
- Potentially pass any remaining assets in the PAT to his heirs income tax and estate tax free.

The Private Annuity Trust can be a great strategy for the right situation. If you have any questions how it might work for you, please let us know. 


### *charles*SCHWAB news:

Schwab Institutional now offers **Trade Confirmation Reports** for clients who would like to reduce their daily mail.

The Trade Confirmation Report is mailed quarterly and consolidates trade confirmations.

Benefits include:

- Reducing the amount of paper you receive.
- Consolidating multiple accounts and tracking trades in one document.
- Simplified record keeping for file management and tax return purposes.

If you are interested in receiving consolidated trade confirmation reports, please give us a call at 847-359-6262. 

### **Detterbeck Wealth Management, Inc.**

220 N. Smith Street, Suite 410, Palatine, IL 60067

*Phone: 847-359-6262*

*Fax: 847-934-5495*

[www.detterbeck.net](http://www.detterbeck.net)