



## A Family Way

Can an inheritor protect both long-held family assets and her own financial future?

### SCENARIO

RACHEL ALTMAN IS A YOUNG WALL STREET professional who stands to inherit in excess of \$10 million in liquid investments, as well as more than \$10 million in illiquid real estate that has been passed down across several generations in her family. Her current assets are approximately \$5 million. Additionally, she is a highly sophisticated and well-compensated professional, with annual earnings ranging from \$1 million to \$3 million.

Altman is engaged to be married and plans to start a family within the next two years. She has no life insurance, nor does she have a will in place. Because of the potential size of her estate, she is understandably concerned about estate tax exposure, as well as asset protection. Additionally, the real estate she will inherit will likely never be sold, and therefore no income will be generated to pay property and estate taxes.

Altman has asked for advice regarding a prenuptial agreement in order to protect the family land. Her assets are invested primarily in long-only U.S. equities. She is concerned about the correlation of the stock market and economy with her annual compensation and is curious about opportunities in portfolio structuring to diversify the risks.

Because of her large earnings potential, long time horizon and high level of absolute wealth, the client is opportunistic with regard to her investments. She would like to continue to grow the principal on a real (inflation-adjusted) basis. Altman suspects that the cost of services, healthcare and travel—where the wealthy spend a disproportionate amount of their wealth—are appreciating considerably faster than the consumer price index in general.

—The Editors

Based on their experience in providing comprehensive financial counseling to corporate executives, entrepreneurs and professional athletes, WORTH's editors asked executives at RR Advisory Group to respond to our hypothetical scenario.

### RESPONSE

AT RR ADVISORY GROUP, we focus on integrated solutions in order to develop a cohesive strategy that addresses the many facets of wealth management: estate and tax planning, insurance advisory and investment strategy—all of which are inherently linked.

Customized and integrated planning is especially critical for Wall Street professionals. Annual incomes are generally correlated with financial markets, and estate tax planning generally must begin at a surprisingly early age. Additionally, high marginal tax rates require an emphasis on after-tax returns. Developing effective strategies requires a long-term perspective combined with a comprehensive approach.

#### ESTATE PLANNING

**GOAL:** Protection and planning for distribution of existing assets upon death.

**RECOMMENDATION:** Create a will, which includes testamentary trusts, such as a credit shelter trust and possibly a qualified terminable interest property trust (QTIP). This will allow the client to control how, when and to whom her assets will be distributed in the event of her death. The credit shelter trust allows for efficient use of her estate tax exemption (grows to \$3.5 million in 2009), minimizes the subsequent estate tax upon the spouse's death, and allows her to choose the eventual beneficiaries of the remaining assets. Those assets that remain in her name, specifically the \$20 million inheritance, could be placed in a QTIP trust, which utilizes the unlimited marital deduction to defer estate tax until the death of her husband. It also provides



### SCENARIO PLANNING

continued

her husband with an income interest in the assets for life, and allows Altman to control the distribution of the inherited assets upon her husband's death.

#### PRENUPTIAL AGREEMENT

**GOAL:** Protect inherited family assets in the event of a divorce.

**RECOMMENDATION:** Altman already has a substantial estate prior to her upcoming marriage. Generally, assets that are acquired or inherited prior to marriage are not considered marital property unless there is commingling with funds obtained during marriage. A prenuptial agreement may make certain that these assets are kept within her family. The prenuptial agreement should be drafted in contemplation of her will in order to prevent any conflicts.

#### INSURANCE PLANNING

**GOAL:** To hedge human capital (i.e., wage income), add a lifetime investment aspect and ultimately provide liquidity for estate taxes.

**RECOMMENDATION:** Life insurance is perfectly negatively correlated with an individual's wage income, providing the necessary hedge to protect the insured's family from the potential loss of income. In the context of an investment portfolio, whole life insurance provides tax-deferred, fixed-income-like returns. Building cash value on a tax-deferred basis within a life insurance policy is simply an exercise of asset location—holding assets that generate ordinary income and would otherwise be subject to high marginal tax rates in tax-deferred vehicles. The tax-deferred internal rate of return on the cash value compares to the taxable return of many fixed-income investments and should be modeled as such. Additional benefits of cash value life insurance are creditor protection (in certain states) and flexibility with regard to access of funds. Cash value life insurance is an efficient means of paying estate taxes, particularly on non-income-generating assets such as real estate. The policy should be purchased within an irrevocable life insurance trust in order to avoid having the proceeds included in the taxable estate.

#### INVESTMENT STRATEGY

**GOAL:** Portfolio diversification with an emphasis on providing real after-tax returns that are less correlated to the client's wage income.

**RECOMMENDATION:** Altman has a high level of sophistication and knowledge of financial markets. Combined with an opportunistic nature, long-term horizon and high level of absolute wealth, we recommend the following portfolio structure:

- 10 percent investment-grade bonds
- 60 percent global equities
- 30 percent alternative assets (real estate, commodities, private equity, hedge funds)

**FIXED INCOME:** Given that the whole life insurance is in place and the low real returns attributable to fixed income, we recommend an allocation sufficient to serve any potential short-term liquidity needs without subjecting the portfolio to the significant opportunity cost of holding bonds over long time horizons. By integrating these assets into a cohesive framework, overall portfolio volatility and equity market diversification can be controlled by the inclusion of other asset classes.

**EQUITY:** The global equity allocation would include exposure to high-quality domestic, international developed and emerging market equities. International and emerging market exposure provides currency diversification, as well as exposure to strong global growth. Approximate weights for the equity allocation are:

- 25 percent U.S. large- and mid-cap
- 5 percent U.S. small-cap
- 30 percent international and emerging markets

**ALTERNATIVE ASSETS:** Alternative assets reduce dependence on traditional equity markets, providing powerful diversification potential combined with attractive returns, resulting in a portfolio structure with higher anticipated risk-adjusted returns.

Commodities are inflation-hedging by nature and are driven by different fundamentals (supply and demand) than stocks and bonds, and therefore they contribute meaningfully to diversification. Real estate investment trusts (REITs) and commercial real estate securities also benefit from strong global growth, low unemployment and higher incomes, along with the additional benefit of low historic correlations to both equities and residential real estate. Because real estate appreciation is a highly localized phenomenon, global diversification is paramount. Value creation within private equity can contribute to enhanced portfolio returns, whereas a properly constructed hedge fund portfolio, one that is composed of managers that can profit during market dislocations and volatility, has the potential to reduce market exposure and overall portfolio volatility, which then allows for the faster compounding of wealth.

- 20 percent hedge funds, fund of funds, private equity
- 5 percent commodities
- 5 percent REITs (globally diversified) □

Rosario J. Ruffino, CPA, CFP, M. Cullen Thompson, CFA, and Justin McCarthy are with RR Advisory Group in New York.

