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Q4 Wanger Investment Quarterly Letter

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From the Editor

Michael Kelnosky

In 2009, Wanger Investment Management, Inc. and OmniWealth, Ltd. joined forces to create Wanger OmniWealth LLC, a unique firm dedicated to providing family office and institutional-level investment solutions to highly successful families. Wanger Investment Management continues to operate its growing suite of active strategies, which now includes the Wanger Long Term Opportunity and Wanger Income and Growth strategies. Wanger OmniWealth is a continuation and expansion of OmniWealth, Ltd. Whether you seek individual investments or comprehensive wealth management solutions, Wanger can help! Please contact us for more information.

What do we expect for 2010?

Eric Wanger

2009 was an exciting year. It started with the end of the world and finished with euphoria, an early bull run—maybe too early—but certainly convincing in its extent. 2010 will present us with trends that are less clear. Bonds are no longer dirt cheap, spreads are no longer exceptionally large, and equities are no longer available at give-away prices.

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Boardroom Wars

Ralph Wanger

Being a securities analyst is a good job. It pays well, it is intellectually interesting, has a bit of variety, and allows you to work indoors in the winter time. It would be a great job if only we didn't have to deal with our clients. One of the irritating things customers do, in years such as 2009, is decide to sell out at the bottom. So they miss the next rally, blame you, and fire you. What were the fools thinking?

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Lessons from 2009, Mr. Market has a wild ride

Bill Andersen

In his book *The Intelligent Investor*, Benjamin Graham uses a famous metaphor to describe how financial markets work. Mr. Market, according to Graham, is a highly emotional person who is always ready to purchase or sell shares in any company at whatever price the market is quoting that day.

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Family Office Corner

What is a family office and how do I get one?

Don Scott

As our initial article on the subject, this seems an appropriate question. What do people mean when they say "family office?" A better question might be: Why would anyone care? You care if "being wealthy" is getting more and more stressful and complex. That covers most everybody. We just don't run across many high-net-worth families whose situations are truly simple.

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The uncertain fate of estate and gift taxes

Gail Potysman Bley, CFP®, Gould & Ratner LLP *with contributions from Eric C. Nelson and Julie S. Pleshivoy, Gould & Ratner LLP*

The estate and gift tax laws in effect today are uncertain at best. Despite last-minute efforts by Congress at the end of 2009 to preserve the federal estate and generation-skipping transfer ("GST") taxes, the scheduled repeal of these taxes for 2010 has gone into effect—or has it?

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WANGER INVESTMENT MANAGEMENT

WANGER OMNIWEALTH LIFE ENRICHED

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From The Desk of Eric Wanger:

What do we expect for 2010?

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Eric Wanger

The velocity of money has a lot to do with the quality of parties. It is pretty easy to understand why the parties have gotten worse over the last few years.

The tea leaves are quite hard to read right now. Everyone seems to be talking about inflation given the huge federal stimulus, though it is not yet present. In fact, certain kinds of prices like housing and energy are cheaper than they've been in past years. Yet the Fed is going to have to start raising key interest rates to choke off another stimulus bubble (unless it's already too late to stop it). Until that time, the federal government will continue to do everything in its power to keep bond yields at artificially low levels. The government is still working to give banks the ability to shore up their balance sheets with loans costing them virtually nothing to fund, while propping up the value of treasury and agency securities. The federal deficit! The federal debt!

Why Have the Parties Gotten Worse?

This is a chart of the "velocity of money" measured by dividing U.S. GDP (a measure of economic output) by M2 (a measure of the money supply). This is a lot like an inventory turnover ratio you might find in an ordinary business. How many times was each dollar used and reused by the economy during the year? The more times each dollar is pushed through the system, the "faster" the velocity of money. The velocity of money has a lot to do with the quality of parties. It is pretty easy to understand why the parties have gotten worse over the last few years.

Bloomberg: Velocity of money (VELOM2 index) U.S. GDP/M2

Things to Notice:

First, notice how dramatically the velocity of money increased during the 1990's. Those were euphoric times when credit and investment flowed freely.

Second, look how dramatically we fell during the last few years. In chart terms, we've reset the speed of flowing dollars all the way back to the mid-1980's. There is no doubt that tighter credit and significant de-levering have slowed down the speed of money flow. As a result, the parties aren't as good.

Third, notice the little uptick at the right side of the chart. Have we hit a bottom or just taken a breather? It would be great to know, but unfortunately we don't. The chart would seem to imply that we've dropped down near the historic lows for this measure.

The conclusion I draw is that the great "unwinding" has taken place and has been pretty thorough. While it seems unlikely that we will see a heady return to free-flowing capital and great parties for a few more years, it also seems unlikely that we will witness significant slowing from here going forward. The wildcard is what happens when the government slows down the stimulus.

The government has been spiking the punch. Hopefully, that means the party is going to get better. We do know that banks have been given every possible incentive to lend: They can borrow money at extraordinarily cheap rates and the government has been propping up many of the assets banks use to support their balance sheets (such as treasuries and mortgage-backed securities). However, we also know that, even with hundreds and hundreds of billions of dollars in stimulus, the economy still feels uncomfortably shaky.

Some commentators speak of the "new normal," an economy with tighter credit and lower velocities. Others think that the cycles of greed and fear will continue as they always have. Either way, this graph makes me feel like we've already experienced a decent amount of the pain and things will be getting better.

The New Normal is the Federal Deficit

Here's another chart to ponder. This one overlays the U.S. federal deficit (as a % of GDP) and the U.S. Unemployment Rate (seasonally adjusted).

What are some features to notice?

First, look at that deficit spike on the right. Holy smokes! That's the worst federal deficit (as a % of GDP) since who knows when.

Second, notice that unemployment is actually not the worst it's been since the 1960's. Despite the rhetoric, in this respect,

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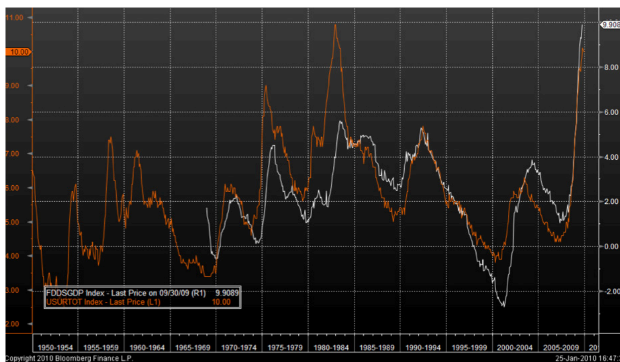
What do we expect for 2010? (Continued)

things certainly have been as bad and even worse in recent times. Recall, however, that people who have given up looking for work are not counted in the official unemployment figure. During this recession, that's a lot of uncounted noses.

Third, notice how the two lines move. Things tend to get "bad" quickly and improve more gradually. It's not at all clear that we've reached the maximum of "badness" yet and, even so, history would suggest that it will take a few years for things to get "better."

Remember, the federal deficit is a one year deficit figure. Paying back the debt requires digging out from the sum of all the past deficits added together!



Bloomberg: FDDSGDP INDEX overlaid by U.S.URTOT INDEX: U.S. Federal Deficit (as a % of GDP) and Unemployment Rate (seasonally adjusted)

Investing in 2010

It seems pretty likely that the "end-of-year everything is back to normal" head-rush we all felt at the end of 2009 has run its course. There is no shortage of commentaries discussing the ambiguity of the present situation. But it seems like a more interesting challenge to try to discuss the things we do know for sure and try to figure out where they might lead us. As you know, we like to base our bottom-up investment picks on significant long-term trends. We see some interesting and definite trends:

- **U.S. Competitiveness:** American industry, including manufacturing, has done a significantly better job of improving productivity and efficiency through the downturn than most equivalent firms in Europe. This is the flipside of unemployment and should help American firms compete as things get back on their feet. While a cheap dollar dilutes our international unilateral muscle and raises the cost of imported goods, it will dramatically improve the competitiveness of U.S. exports. Despite popular wisdom, we are still a global manufacturing power and have some of the best food, defense products, services, entertainment products, and electronics in the world.
- **Real Estate:** Commercial real estate is still in deep trouble. The popping of the commercial real estate bubble has still yet to fully play out. While residential real estate has already taken a lot of its fall, there is still a long road to recovery. The amount of crap debt still on the books of banks will take additional toll.
- **Internet:** The music, movie, publishing, radio, TV, and cable industries are about to go through another period of vicious fighting and consolidation as online streaming, mobility, and the iTunes-ization of everything continues. Internet commerce is still making great strides in rewriting the behavior of consumers and businesses in the U.S. and the world.
- **The Dollar:** On average and over time the damage we've done to the U.S. dollar must take its toll. It simply isn't worth as much as it once was. There is no denying that fact. Once again, however, this could take long time to play out.
- **Treasuries:** The yield curve is extremely steep. Investors all want extremely short duration bonds and dislike long dated notes. The U.S. government can't keep propping up treasuries forever, and eventually interest rates must go up (i.e. the value of treasuries must fall). Therefore, bonds must fall also. Once again, the only question is when.
- **War:** Our presence in Iraq and Afghanistan are both going to be political, military, and economic fixtures for some time to come. Foreign wars are expensive in every sense. The U.S. may be fully-extended militarily, certainly in the present economic and political context.
- **Energy:** Energy in this country is going to be strangely and unusually cheap for the near term. We are awash in cheap domestic natural gas in a way that no one could have predicted only a few years ago. The price of coal in China is 50-100% higher than the spot price in the U.S. Furthermore, natural gas is transitioning from being a regional commodity (pipelines) to a global commodity (shipped via liquefaction). Coal, uranium, and oil will stay "cheap" until they get very, very expensive again. The only question is when.
- **China:** China will continue to flex its growing economic and military muscle. Eventually they will tire of lending

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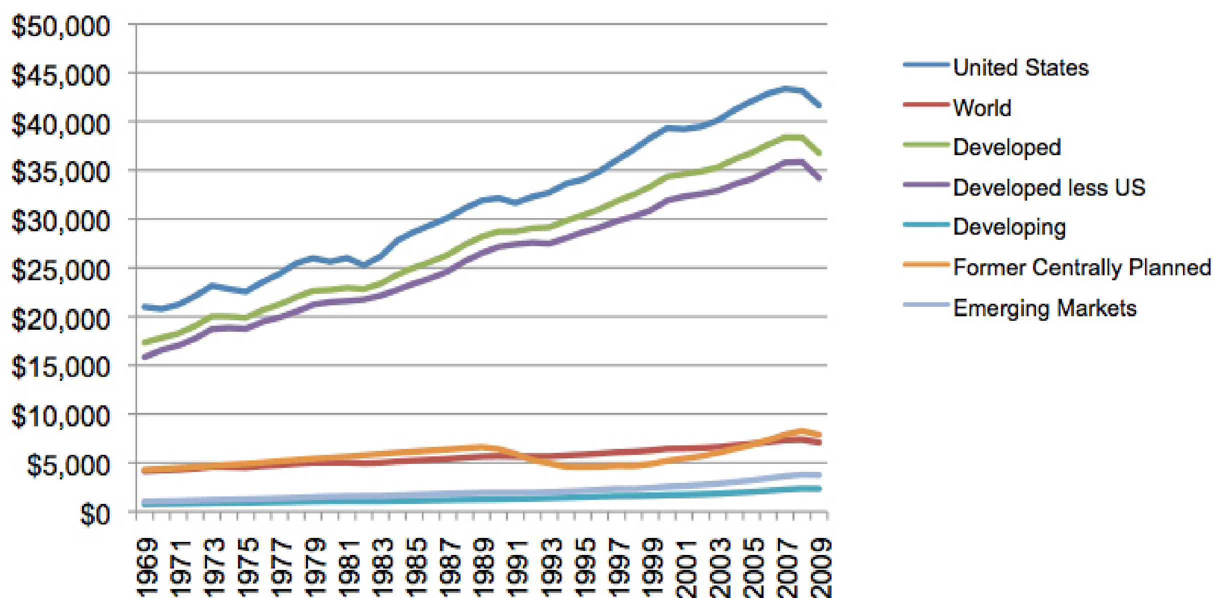
What do we expect for 2010? (Continued)

us money, especially if we continue to use it to antagonize their interests. China has a voracious appetite for natural resources. Will their banking and real estate bubbles burst or will their heady times continue? My prediction is that they will see boom/bust cycles that will make the U.S. 19th century blush. We'll see how I do on this one.

- **Brazil:** Brazil is going to be "China" before China is going to be China. In other words, economic development in Brazil is significantly farther along compared to China. In addition to its amazing oil resources, Brazil has an impressive manufacturing base and a solid (at least until recently) economic base.

America is Not Over

My sincerest hope for 2010 is that we will finally see the end of 2008. However, I cannot be more emphatic: America is not over!



Real Historical Gross Domestic Product (GDP) Per Capita (in 2005 dollars) 1969-2009 Source: ERS International Macroeconomic Data Set http://www.ers.usda.gov/Data/macroeconomics/Data/HistoricalRealPerCapitaIncomeValues.xls

People who bemoan the demise of the United States might want to look at these charts. The most interesting question to me is how long we've been able to defy "mean reversion" to world averages. Now without accidently challenging any actual economists to an intellectual wrestling match, if you measure long-term wealth averages using just about any useful statistic, the United States became the wealthiest nation in the world (arguably in the history of the world) by an impressive margin and has remained so for a surprisingly long period. This is even more remarkable if you factor in the cost of the Cold War and the startling rates of growth in other parts of the world.

Maybe you don't like how the trends feel, but numbers don't lie. America is far from over.

Eric Wanger, JD, CFA, *President of Wanger Investment Management, Inc. and Portfolio Manager, Wanger Long Term Opportunity Strategy*

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Family Office Corner – By Don Scott:

What is a family office and how do I get one?

(Continued from page 1)

A Brief History

Ultra wealthy families have had these things for decades, but they really weren't called "family offices." That term came about later, and family offices experienced a real rise in popularity throughout the '90s. Ultimately, many began to realize that a family office, done right, is a very expensive proposition. The Family Office Exchange is considered to be the leading organization in the field. It has indicated it typically takes a few hundred million dollars of investable assets to cost-justify a fully functional family office.

Classic Description

Consider the billionaire entrepreneur. He or she sells out and the money becomes the business. The family rents space, hires employees, purchases technology, engages various outside professionals, develops vendor relationships, puts processes and protocols in place, develops a mission, and much more. Envision a small business just to take care of the money and everything having to do with money.

The functions vary widely and might include:

- **Investments**—A family office might have investment professionals in house. They might work with an outside investment consultant along with the in-house people, or in lieu of them.
- **Accounting**—There are accountants who keep the books for the various entities and family members. They pay bills and deal with all matter of related issues. There is typically an outside CPA firm as well.
- **Income tax**—There may be internal income tax professionals. There will typically be outside tax accountants. This covers all of the tax return filings and tax planning. It's a massive job as things tend to get more and more complicated.
- **Estate planning**—This may vary even more. Typically, the heavy lifting is left to the estate planning attorneys, CPAs, insurance professionals and others. However, the family office will have an active role in the planning and administration of the planning.
- **Administration**—There is a ton of filing and just every day "stuff." The administrative staff keeps all of that humming.
- **Lots more**—This basic summary can only begin to paint a picture of a large, comprehensive family office. There are trusts, all matters of insurance, multiple homes, cars, planes, multi-generations, banking and financing needs, big things, little things…

Complexity is a Fact of Life

Highly successful families are all different, but also have many similarities. They want the most sophisticated and effective investment strategies. They want access to the best managers and structures. They have to file tax returns and desire—more than ever—to manage taxes to the lowest levels the law allows. They have children and grandchildren, trusts, and estate issues. I have long believed a family with $20 million has virtually the same needs as one with $200 million. Maybe the extra zero adds a few headaches; however, once we start talking about millions of dollars and all that goes with it, there are lots of moving parts.

So, what happens with a family with X million dollars and without a large family office? Who deals with all the pieces of their lives? The family office world consists of an external network (CPAs, attorneys, money managers, and others) and an internal network (the family office itself). With most high-net-worth families, it becomes a "hub and spoke" scenario. The external network is there. The outside advisors and other resources are all out at the end of the spokes. Mom and/or Dad sit in the hub.

Without the family office internal team, the family finds the burden of management, follow up, and just getting it all done, squarely on their shoulders. To be sure, they have lots of help—that external network. However, the real burden of responsibility rests with the family. Some are relatively comfortable with this scenario, while others are disturbed. Potential downsides include:

- Takes time away from whatever they would like to be doing
- More worries and headaches
- Time delays (e.g. estate planning is deferred)

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What is a family office and how do I get one? (Continued)

- Things that should get done don't (perhaps deferred indefinitely)
- Wealth is sub-optimized
- Life is sub-optimized

Accessing the Inaccessible

We believe all high-net-worth families deserve the sorts of resources and solutions available to the billionaires. Whether they have some level of internal family office or none at all, the answer may be to overlay an outsourced family office. Unfortunately, many firms call themselves "multi-family offices" which are in fact nothing more than wealth managers. Careful investigation is required. Families should seek and consider a solution that can provide the end results of the fully-staffed family office on a just-in-time basis.

Providing a family office that delivers the results clients need is a complex and labor intensive business. However, it can be life changing for those high-net-worth families who have been carrying the burdens of complexities on their own shoulders.

Speaking to the model we know best, the WOW Family Office essentially resides at the intersection of wealth and life. We provide clients with the personnel, technology, other resources, and management to optimize the impact of their wealth and simplify their lives. An effective investment strategy with unique access is a critical part of that solution.

Summary

A family with $10 million, $20 million or more has much of the same complexity, and certainly the same desire for the best solutions, as those with hundreds of millions. This article summarized the characteristics of the classic family office. It may take hundreds of millions in assets to justify a fully-staffed family office. However, clients can nonetheless have their own family office on an outsourced basis. It really can be life changing!

Don Scott, *Chief Executive Officer*
Wanger OmniWealth, LLC

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Ralph Wanger Reports:

Boardroom Wars

(Continued from page 1)

Ralph Wanger

I spent many years trying to keep people from mishandling their money. Now I am spending my declining years on investment committees, trying to keep investment consultants and money managers from mishandling an endowment's money. In the typical investment committee meeting, all the people in the room are honest, well-meaning, and knowledgeable. The number of bad decisions, and the level of animosity so engendered, seems hard to explain. I now think, however, that some elementary Behavioral Finance theory helps with the explanation.

Most investment committees believe that their main job is establishing asset allocation rules. They select what percentage of the money they should invest into stocks, bonds, cash and alternatives. To simplify the problem for this discussion, let us reduce the asset classes to two—a stock market index fund and a bond market index fund. Now the job of the committee is to ignore its consultant, guess a percentage to put into equities, and go to lunch. You are a distinguished member of this investment committee managing the endowment of Embraceable U. The market has been pretty good for the last year, so a 70% equity allocation sounds fine, and you vote for it. For the next year, the stock market goes up, and everyone feels proud of their investment skill. But then the market takes one of its unpredicted downward lurches. The committee commands the presence of the consultant and furiously demands that all equities be sold. How come?

If the market is fairly quiet, a 70/30 allocation works fairly well, because any fixed allocation acts as an automatic rebalancing program. The policy forces the endowment to sell stocks when the market goes up a bit, and then buy them back again when the market goes back down. So, most of the time, everyone is happy. Happy until the market takes a steep dive, as it did in the fall of 2008. Then the consultant is summoned to the investment committee. She says "This is a very unusual event that no one could have possibly forecast. Now it is time to rebalance, so at least you will be investing your cash at some very good prices." The response to that is savage and unexpected "We cannot afford to take more risk at this time." The committee chairman continues his outburst, "We want to reduce our equity allocation, so sell the pitiful remnant of our portfolio. By the way, we are starting a search for a new consultant, because you are fired!" Why did this pleasant, urbane, experienced trustee turn into a fierce maniac?

One's first thought is usually betrayal. When we set up our 70% equity allocation, the market was moving along in a general uptrend, and investment committee meetings were cordial and self-congratulatory. The committee was "summer soldiers" who enjoyed their popularity with the board of trustees as long as they showed money-making acumen. Then, a bad market comes along, and at the first sound of hostile gunfire, the old fools panic, drop their muskets, and run. When I was a portfolio manager, I cursed their perfidy. However, now that I am one of the panicky old fools, I have to justify our volatile behavior.

Endowment assets come in different sizes, following a power law distribution, with a few giants, a lot of middle-size ones, and a great many small endowments. Let's concentrate on small endowments, because they are the ones that you are most likely to run into. Small endowments will usually have a consultant suggesting investment strategy, and a committee that follows the advice of the consultant, since the organization cannot afford a professional investment staff. The investment committee will be made up of responsible trustees who often have considerable experience in finance, but any investment committee has defects.

One committee problem is a very long decision time. It is hard to get any change voted in less than three meetings, and some take five meetings, so if the committee meets quarterly that means it takes about a year to get anything done.

A second defect is a lack of institutional memory. If committee members serve for three years, and there are six members, then there are only two members around long enough to remember the last disaster. This perpetual inexperience promotes the leadership role of the consultant.

Will the investment committee use leverage?

The acceptance of a leveraged balance sheet for EU is worth thinking about. Suppose the school had only a $20 million endowment. A nicely dressed CFA comes to the President's office and suggests a deal; his bank will lend EU $80 million in return for $80 million in tax-exempt bonds. The school can then invest its $100 million in assets at a positive carry, receiving high yield on its $100 million investment but paying a lower yield on its tax-exempt obligations and profiting on the spread. Would this leveraging of the balance sheet be approved by the trustees? I believe that in most cases the board would reject such a strategy, on the grounds that a drop in the market would put the endow-

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Boardroom Wars (Continued)

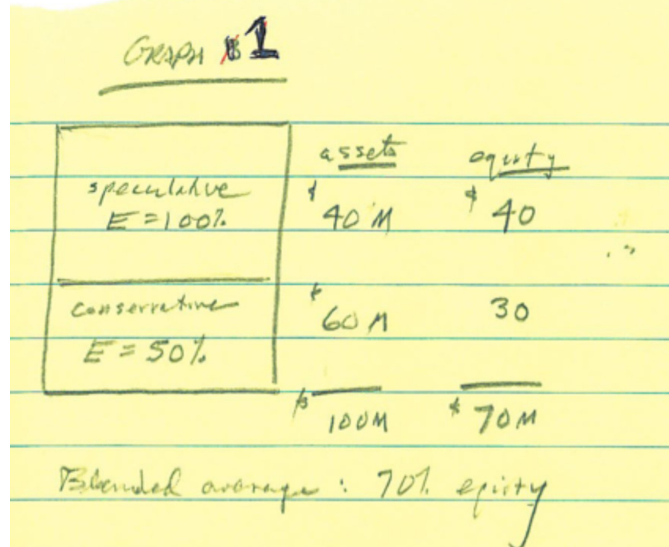
ment assets below their debts, triggering defaults on the bonds. The school would be bankrupt, fighting desperately to find some other college to take it over and allow EU to keep its doors open. The trustees would be humiliated and subject to lawsuits. The chances of such an ugly outcome would cause many trustees to vote against this leverage strategy.

However, if the EU had a $100 million endowment and had the same pressing need for $80 million to rehabilitate its physical plant, in my experience the school will in fact sell an $80 million bond issue, leveraging up the balance sheet, and hope for the best. This is clearly a risky strategy, for a 25% drop in endowment assets would trigger default on the debt, but the trustees will be willing to leverage up rather than liquidate most of the endowment.

The endowment fund is an asset of Embraceable U, but in many cases there are also liabilities. Perhaps the building inspector rated Ivy Hall three years ago and declared the old dorm uninhabitable. The board agreed to sell $60 million in tax-exempt bonds, $40 million for Ivy Hall repairs and $20 million for updating classrooms and labs, God knows they needed it. The $100 million endowment assets, of course, are pledged as collateral on the bonds. So, if you look at the balance sheet, it is now highly leveraged. This is not a hypothetical example; there are many organizations where the debts are 100% of the endowment assets. If the market drops, Embraceable U has a real problem.

The investment committee will act as if they do not regard their investment portfolio as a unitary thing. Instead it is divided into conceptual layers, as suggested by the Behavioral Finance gurus. For instance, they might regard the first $60 million in the endowment as a conservative reserve that will be 50% in equities. (Remember that the institution has borrowed money for deferred maintenance, and if the endowment goes below $60 million, we default on a loan covenant.) The next layer of $40 million is investable, so an asset allocation of 100% in equities would allow the funds to grow. If the total endowment is $100 million, you would end up with a blended equity rate of 70% (graph 1). Just what the committee voted. Again, time passes. If the stock market goes up, there will be some pressure on the committee to increase equity weightings, because there is more money in the second zone where 100% equity is the desirable allocation. This is a pleasant decision to make, because the endowment has been making money, and everyone is quite pleased with themselves. There will be a push to increase the equity percentage to 80%, in a fit of euphoria. This occurs about three months before the market peaks, and will cause tears later.

graph 1



The crisis erupts when the market goes down sharply, so there is very little money in the 100% equity layer, and the $60 million reserve layer is threatened. Oh, my! If the market continues to dive, the fund could collapse down into the first layer. Panic time! We have just been reminded that we will be in default. Our loan will be called. We have no way to repay. That is why we call in the consultant and sell our stocks.

Another conceptual way to think about the endowment problem is that the investment policy is not simply a parameter, but is in fact a variable. The desired allocation percentage changes if the market makes a dramatic move in either direction. If you are trying to guide the endowment investment committee it would be wise to keep this in mind. You can try to control the reallocation process in order to make sure that the fund does not threaten to drop to the level one crisis zone. That is easy advice for me to give and doggone hard advice for you to follow.

Another way to describe the shift in investment policy with market results is to acknowledge that investment policy has a positive beta.

If investment policy is a function of the size of an endowment, this might explain data that I always found mysterious. NACUBO data show that past performance of college endowments was clearly related to the size of the endowment. Big endowments had higher returns than little endowments (chart 2). In principle, little endowments can hire consultants and investment managers who ought to be just as smart as the consultants and investment managers that big endowments can hire. One could even hypothesize that small endowments could do very well because of their ability to invest in small but enticing op-

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Boardroom Wars (Continued)

portunities that would not make sense for large, clumsy organizations. But the data shows otherwise. The most reasonable interpretation of the data is that large endowments take more risk than small ones. The giants have favorable long-term results because risky portfolios have higher returns. But why should small endowments act in a risk averse way? If as shown above, the investment policy of an endowment gets more conservative if the assets are smaller, then behavioral Finance may explain why the rich endowments keep getting richer.

NACUBO Data (year ending June 30, 2008) *chart 2*

Investment Pool Assets	Compound Annual Return	
	3 year return	10 year return
Greater than $1 billion	12.0%	9.5%
$500M - $1B	9.6%	7.6%
$100M - $500M	8.5%	6.4%
$50M - $100M	7.4%	5.8%
Under $25M	5.7%	4.8%

The NACUBO figures for the periods ending June 30, 2008, show a perfect ranking between return and fund size. This time period rewarded risk-taking and alternative investments. The data suggests an obvious strategy; if two schools each have $100 million endowments, then they can do much better by simply merging the endowments. Some did this, by moving their assets into Commonfund or a similar structure, but most committees stay independent and keep trying to get good results from a small fund.

The 2009 NACUBO results are not out yet, but will show a much changed picture, possibly too gory to display in this dignified journal. The same high-risk, illiquid alternative investments that helped returns up to June 30, 2008, did poorly in 2009 and have forced EU and its fellow schools to make sharp cuts in expenditures. Being an endowment administrator has been a stressful and unpleasant job for the last year.

Ralph Wanger, CFA, *is Senior Advisor to*
Wanger Investment Management, Inc.

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Bill Andersen:

Lessons from 2009, Mr. Market has a wild ride

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The great thing, according to Graham, is that Mr. Market doesn't care whether or not you accept his offer to buy or sell; he will always be back the next day ready for a transaction at that day's price.

Those who think metaphors such as these are relics of the past with limited current value would be advised to consider the behavior of markets the past couple of years. In 2007, Mr. Market (who is clearly active in credit as well as equity markets) was willing to lend money to individuals and institutions of extremely low credit worthiness at very attractive rates. Sub-prime borrowers, investment banks with 30:1 leverage, consumers with multiple credit cards all charged up to the maximum, are just a few examples. Then, the crisis came and Mr. Market's mood swung the other way. Suddenly, the most credit worthy customers had trouble getting loans. Investors who had previously purchased high yield credits with expected returns of just a few percentage points above Treasuries now required a premium of as much as 20%. At the other end of the risk spectrum, investors were now willing to purchase U. S. Treasuries at yields of zero just for their safety value. Otherwise intelligent people we know contemplated installing safes in their homes, presumably to store their cash and ammunition.

Such was the situation in March of 2009. Sentiment was terrible and the outlook for the economy was bleak. In the midst of this darkness, though, a few financial institutions commented that their profitability was improving. Citibank made comments that its first quarter had been very good, and these results were echoed by other firms. Essentially what banks were saying was that, with their cost of funds near zero (due to an accommodative Federal Reserve), and with Mr. Market now paying them a very good return on their loan book, their profitability had gone through the roof. At some point, this increased profitability became more significant for their earnings outlook than the huge write-offs which seemed to ruin each weekend during the second half of 2008. The cycle had once again turned. With Mr. Market about as negative as ever, the stage was set for a huge rally. As is common, the leaders in the rally were the groups which had been most decimated during the decline: financials, emerging markets, small cap value, and junk bonds. Safer, high quality stocks mostly lagged in 2009.

Economic performance was much better than expected in 2009, in both developed and emerging economies. It is hard to recall, but at the beginning of 2009 most economists were predicting the recession/depression would last well into 2010 or beyond. We now see that the recession ended most likely in the third quarter of 2009. The emerging economies of Asia, which had experienced dramatic slowdowns in 2008, experienced true "V" shaped recoveries. The recovery has been more mixed in other developing regions such as Eastern Europe, but the overall picture has certainly improved.

The outlook for 2010 is fairly good in our view. While the recovery in financial markets has been substantial, it is worthwhile to remember that it came from very depressed levels. Prices are still in the range of fair to attractive in our view. Financial market recoveries often precede economic recoveries by a substantial amount of time and that could very well be the case in 2010. (For example, recall that the stock market bottomed in the fall of 1990 but the economy was still weak enough two years later that the U.S. voted out the first President Bush.) Interest rates are likely to stay low for some time which will be good for profitability in many sectors. If history is any guide, banks will soon start to loosen their lending practices again which will provide a stimulus to growth as the impact of government programs wears off. As several commentators have pointed out, severe slowdowns in the U. S. economy have often been followed by very strong recoveries (the evidence isn't as clear following financial crises such as this one). In our view, a strong recovery in the U. S. could be the biggest surprise of 2010. And the continued strong growth in China and India, with their demand for commodities, capital equipment, luxury goods and capital will also support the economies around the world.

There has been a lot of talk in recent years about the profusion of "bubbles" in the global economy. Technology stocks, real estate, hedge funds, the stock market, emerging markets, etc. have all been included in this category. Two questions which are almost never addressed are: 1) How does this tendency keep happening? and 2) When is the next one is and what will it be? As to the first question, readers would be well advised to read George Soros' book from the 1980's, *The Alchemy of Finance*. The first few chapters, especially the one called Anti-Equilibrium, give the best description of how financial bubbles form and play out, as we've seen. It is truly a blueprint for what happened over the following quarter century. The following is a drastically simplified statement of his views. According to Soros, bubbles are the result of self-reinforcing processes which cause an investment idea (which may have been sound at the beginning) to be taken to extremes. As an example, he cites the REIT boom of the early 1970's. An interest in real estate led to increased interest in real

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Lessons from 2009, Mr. Market has a wild ride (Continued)

estate securities known as Real Estate Investment Trusts. In turn, these companies were able to raise more capital which they then invested in real estate which caused further appreciation. A cycle of this nature can continue until prices reach ridiculous extremes. In the most recent cycle, lenders in the residential real estate sector justified increasing valuations on recent transaction values but failed to understand the extent to which their lending activity was one of the key reasons prices were going up. The problem was exacerbated by the fact that lending standards were steadily falling all through the cycle. Soros argues that these cycles are difficult for most analysts to spot because they fail to understand the nature of these self-reinforcing processes. Analysts are trained to look at their profession using a scientific model which assumes there is a correct "equilibrium" price which markets are constantly seeking. They, therefore, are generally wrong at market extremes when prices can always be supported by the data but are out of touch with reality.

If Soros is right, financial bubbles will always be with us, sort of like a chronic condition. However, even chronic conditions can be improved through treatment. We'd like to suggest one which could be helpful in this case: education. In their recent outstanding book called *This Time is Different*, Reinhart and Rogoff have studied 800 years of financial crises and attempted to draw some parallels and lessons from them. Reinhart and Rogoff attempt to make the study of financial crises into a true discipline. Their key finding is that financial crises have many similarities, and that it would be good if market participants understood them better.

The institutions charged with educating analysts and investors include the MBA and CFA programs. While it has been a few years since I completed both of these programs, a little research shows that neither pays much attention to financial history or the study of financial crises. There is plenty of material on derivatives, options, efficient markets, statistics and optimal capital structure. The journals of the business schools are full of articles with equations and theories. None of this research was of much use apparently in predicting the financial crisis. Could it be that a profession educated in the common ways in which such crises develop would have done a better job? It is impossible to say, but it certainly couldn't have done much worse.

As to the second question (when the next one is and what will it be?), here are a few possibilities. The issues listed below are potential crises in the making. While not everyone is a classic bubble, they are all situations where there is an unsustainable process which could end in a crisis. Most will probably be handled before that happens.

Sovereign debt defaults. The United States is charting new territory in terms of its fiscal deficit and so are many countries in Europe. The PIGS (Portugal, Ireland, Greece and Spain) are of particular concern along with the UK. Some people believe even the U. S. could face a financial crisis in the next 10 years.

Quantitative easing exit strategy. Printing money worked well on the way in, and helped prevent a meltdown of the global economy. Getting out of this strategy will be more difficult.

The Euro mechanism breaks apart. There is no particular timetable on this possibility, but as economic performance continues to be more disparate within countries in the Euro, its underpinnings could be threatened.

Chinese Financial System has little transparency. Lots of bad loans were likely made after the crisis to keep its economy growing. A slowdown in China could expose where the problems lie.

Double Dip Recession could happen. The real risk here is that we used virtually every tool last time which could make dealing with a new recession more difficult.

An Inflationary Surge. There are no signs of this right now, but it wouldn't be a surprise given the amount of liquidity created in the past 18 months.

After a financial crisis like the past one, it would be good to see some positive reforms. After the 1930's crisis several important laws were passed which resulted in relative financial stability for nearly 80 years. In fact, it was only when many of these were repealed that a similar crisis followed.

Many have commented that the current crisis was impossible to predict, and certainly the timing and scope of it could not be predicted with any accuracy. But the type of crisis which occurred in 2008 has happened many times throughout history, as shown by Reinhart and Rogoff. Modern market participants such as Warren Buffet, James Grant and George Soros have warned about the potential for such events for years. The crisis was caused by some combination of human nature and a poor understanding of financial markets by policy makers and market participants. While human nature isn't going to change anytime soon, an increased understanding of how and when markets fail by those entrusted with regulating and playing leading roles in the industry would be a good first step in avoiding such problems at least for another generation.

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The uncertain fate of estate and gift taxes

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In 2002, Congress set a course for the repeal of the estate tax for one year—2010. However, their actions over the last months of 2009 have caused the effectiveness of the repeal to be called into question and will make planning over the next year more complicated than ever. In 2009, many bills were introduced, including legislation that the House of Representatives passed on December 3, 2009, that would have made the 2009 estate tax exemption level of $3.5 million and top tax rate of 45 percent permanent. However, none of the proposed legislation passed due to a lack of action in the Senate. It is difficult to predict if and when Congress will act to address the current state of estate and GST taxes and whether the legislation will be retroactive to January 1, 2010. Moreover, if such legislation is retroactive, there will certainly be a constitutional challenge. Although the Supreme Court has previously found a retroactive imposition of an income tax constitutional, forecasting the final outcome of such challenge to estate and GST taxes is impossible.

What does this mean? Will estate and GST taxes be reinstated, and if they are, will it occur retroactively or prospectively? If reinstated in 2010, what will the level of the estate tax exemption amount and the applicable tax rate be; and what will be the rule with respect to the basis of property acquired from a decedent? The answer—no one knows.

Even though the estate tax and GST taxes have been repealed, the federal gift tax has not. However, the gift tax rate was, as part of the 2002 legislation, reduced to a thirty-five percent (35%) rate for gifts in 2010, with the same $1 million exemption that has been in effect since then. Whether these rules will be changed by Congress is also uncertain.

Moreover, without any further change, the assets of an estate of one who dies in 2010 will have, with limited exceptions, a carryover basis instead of the traditional "step-up" (or step down) in income tax basis to fair market value at the time of death. This is likely to increase future income taxes for the surviving spouse and other beneficiaries of the estate of one who dies in 2010.

Under the current tax regime, the federal estate tax and GST taxes are scheduled to again become effective in 2011. Without any further act of Congress, those taxes and the gift tax in 2011 and thereafter will be imposed at the highest rates seen in almost a decade. For decedents dying in 2011, the estate tax rate will again rise to 55 percent with a 5 percent surcharge on certain large estates. The estate tax exempt amount will be $1,000,000 ($2,500,000 less than the estate tax exemption in 2009), the GST tax exemption will be $1,000,000 (also reduced from the $3,500,000 in effect for 2009), the gift tax exemption will remain at $1,000,000 and the basis of property acquired from a decedent again will be adjusted, generally, to its fair market value at the time of death. These rules could potentially cause many estates to unexpectedly pay estate tax in 2011. For example, an estate of a single person with a $750,000 life insurance policy and a $500,000 house would potentially pay estate tax.

Impact on State Estate Taxes

The repeal of the federal estate tax also repeals the Illinois estate tax. However, this is not true for all state estate taxes. As a result, an Illinois resident with real estate in a state whose estate tax has not been repealed will continue to be subject to estate taxes in that other state.

The Disappearing Marital Trust: Planning for Spouses in a Zero Federal Estate Tax Environment

The most serious issue for most clients is the impact repeal has on inheritances for spouses.

Chief among the unintended consequences of the repeal is the problem of the disappearing marital trust. Under typical estate planning documents, two trusts are created after death: a marital trust for the benefit of the surviving spouse and a family trust for the benefit of a group of persons which may include children and/or grandchildren as well as or in lieu of the spouse. At death, the family trust is usually funded with that portion of the decedent's estate that is exempt from federal estate tax and the marital trust is funded with the remainder of the estate. This type of funding is intended to result in no federal estate tax liability for those who are survived by a spouse even if death occurs in a year with an effective federal estate tax.

But if the decedent's death occurs in a year like 2010 during which there is no effective federal estate tax, the funding formula described above will result in the creation of a family trust funded with the decedent's entire estate and no marital trust. Depending on the terms of the marital and family trusts under a given set of estate planning documents, a decedent's surviving spouse could be partially or totally disinherited. The problem is

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The uncertain fate of estate and gift taxes (Continued)

illustrated by the following examples:

Example 1:

H dies in 2009 owning $20,000,000 in assets and is survived by his wife, W, and three children, C1, C2 and C3. H's estate plan provides that a Family Trust, funded with his federal estate tax exemption, will be created at his death for the benefit of C1, C2 and C3 and that his remaining estate will be used to fund a Marital Trust for the benefit of W. The trusts are funded as follows:

Marital Trust for spouse: $16,500,000
Family Trust for children: $3,500,000

Example 2:

H dies in 2010 with the assets described above. The trusts are funded as follows:

Marital Trust for spouse: $0
Family Trust for children: $20,000,000

As a result of H's 2010 death, W is disinherited.

Even if one's spouse is the beneficiary of both the family trust and the marital trust, the disappearing marital trust may also have deleterious income tax consequences that have to do with how the income tax basis of property inherited from a 2010 decedent is determined.

Changing Income Tax Rules

Until 2010, the income tax basis of inherited property was "stepped-up" at death to fair-market value, if it was higher than the income tax basis of the decedent. As a result, the appreciation of inherited assets occurring prior to death generally escaped income tax.

A new modified carryover basis system applies to those dying in 2010. Under the 2010 rules, inherited property will generally have an income tax basis equal to the decedent's basis in the property (i.e. the decedent's income tax basis is "carried over" to his or her beneficiaries) or date of death fair market value, if less. These new modified carryover basis rules, however, allow a limited "step up" in the basis of appreciated qualified inherited property equal to $1.3 million and an additional $3 million step up for appreciated property inherited by a spouse. Other limited adjustments are available based on the decedent's own lifetime income tax attributes.

The second problem of the disappearing marital trust is that if the marital trust is not created at death, then the $3 million spousal basis step-up is lost. This may cause families of those dying in 2010 to incur significant income taxes that could otherwise have been avoided had the 2010 decedent's estate plan been modified to account for the 2010 estate tax law changes.

Recommended Modifications

We are constantly reviewing the legislative developments, and we will keep you informed about any further significant developments. In the meantime, we are available to review your estate plans and implement any necessary revisions to effectuate your estate planning objectives.

At a minimum, plans should be modified to ensure that the marital trust is established in an amount that can absorb the special, spousal $3,000,000 basis step-up and that the family trust adequately benefits the surviving spouse. In addition, for clients with real property in a state whose estate tax has not been repealed by the federal repeal (or for those who reside in one of those states), a marital trust may need to be established to absorb the full state spousal estate tax exemption.

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1. Indexed for inflation.
2. These taxes should be based on the value of the real estate in that other state.

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