MorganStanley
SmithBarney

Dialogues » WEALTH STRATEGIES FOR DISCUSSION

We know how hard you worked to accumulate your wealth, and that key concerns go beyond investing in stocks and bonds. We make wealth work by helping you determine what's important to you, then developing actionable strategies to help you realize your goals and guard against the things that might undo them.

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COURTESY OF
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What's on Your Life List?

Set foot on all seven continents. Learn to play Beethoven's Piano Sonata No. 14 in C-sharp minor. Run the Boston Marathon. Having a "life list" of goals you want to achieve is a growing trend—look no further than the spate of books with the phrase "before you die" in the title, web sites such as www.43things.com or the movie *The Bucket List*, starring Jack Nicholson and Morgan Freeman.

Similar to making a life list, retirement planning also involves identifying long-term goals. In fact, many of your life-list goals and retirement goals may be one and the same. Whether your retirement is 18 months down the road or 18 years, the planning process can help you identify what matters most to you. And because unexpected or milestone events can shift priorities, both your life-list goals and your overall retirement plan may be subject to change—it is life, after all.

When it comes to discussing your goals and creating your retirement plan, it's never too soon to start. We can help guide you through the planning process and access any resources you may require to implement your plan. If you already have a plan in place, it's important to revisit it on a regular basis, to ensure that it's consistent with your life list and the retirement goals you'd like to realize.

Whether it's your life list or your plan for retirement, it's exhilarating to think about the possibilities. But the best part is the clarity you can achieve to help you focus on what really matters—getting the most out of your life. ■

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The Impact of Interest Rates on Wealth-Transfer Strategies

If you borrow money, you know how essential interest rates are. Tiny movements can have a dramatic impact, for better or worse. But what if, instead of borrowing money, you simply want to give it away? Surely interest rates can't affect how you give away money—can they?

For many wealthy families, passing assets to children or charity is an essential part of their wealth plans. Many establish specialized trust vehicles to transfer assets for optimal tax efficiency—in other words, to provide an organized transfer of wealth and perhaps keep the IRS from eating away at what the family is trying to give away.

As you might imagine, identifying the most appropriate trust vehicle for your situation can make all the difference in ensuring that your wealth is transferred successfully to whom you actually wanted to receive it.

Just like with loans, interest rates impact many of these trust vehicles. Some trusts allow individuals to maintain control over the assets they transfer, retaining an interest in the property they are giving away. These gifts are known as "split-interest gifts" and bear unglamorous acronyms like GRATs and QPRTs (see table below for definitions of these and other vehicles).

The value of these retained interests is determined by using tables issued by the IRS under Code Sec. 7520, which are revised monthly by the IRS. When the IRS 7520 rate drops, trust strategies may be affected significantly. In some cases, a drop in rates produces a favorable result, while in others the drop has a negative effect.

The IRS 7520 rate is currently at its lowest point in years (March 2009—2.4%), so if your family is putting together one of the many types of trusts affected by this rate, you should be aware of this, as it could affect your strategy going forward.

The table below gives some specifics as to how certain trusts are affected, but as you'll see, this issue can become complex very quickly. If you believe you may be affected, be sure to have a discussion with your Financial Advisor, along with an estate or tax professional.

Favorably vs. Unfavorably Affected Structures

A lower 7520 rate is favorable for:

- A ***charitable lead annuity trust (CLAT)***, which pays a charitable beneficiary an annuity amount each year for a term you decide, then distributes what's left to a noncharity, such as children.
- A ***grantor-retained annuity trust (GRAT)***, under which you transfer assets to a trust that pays you an annuity each year for a term you decide and then passes what's left to your children.

A higher 7520 rate is favorable for:

- A ***charitable remainder annuity trust (CRAT)***, which pays a non-charitable beneficiary (such as you and/or your spouse) an annuity amount each year for a term you decide before distributing what's left to a charity (the opposite of a CLAT).
- A ***qualified personal residence trust (QPRT)***, under which you transfer a residence into the trust while retaining the right to use the property for a term you decide. When this term expires, the property typically passes to children.

INTRAFAMILY LOANS

The interest rate environment also affects another common wealth-transfer technique—the intrafamily loan. Typically, the senior generation loans funds to the junior generation. The junior generation spends or invests the funds and is obligated to pay the senior generation interest on the loan principal. If the junior generation invests the funds, then a gift-tax-free transfer of wealth to the junior generation will be generated to the extent the investment return is greater than the interest rate on the loan. The senior generation might give the junior generation the funds necessary to make the required interest payments, up to the amount of the annual gift-tax exclusion ($13,000 per year per recipient).

In order to keep annual interest payments small, the senior generation often sets the interest rate as low as possible. But if this interest rate is below a certain minimum rate set by the IRS, the difference is deemed to be a taxable gift. This minimum interest rate depends on the term of the loan. In March 2009, the minimum interest rates for intrafamily loans—known as the applicable federal rates (AFRs)—were as follows:

Note Term	March
Short Term (0 to 3 years)	**.72%**
Mid Term (3+ to 9 years)	**1.94%**
Long Term (9+ years)	**3.52%**

AN INTRAFAMILY LOAN IN ACTION

As an example, using the rates in the chart to the left, let's say that in March 2009, a married couple lends $500,000 to an adult child in return for that child's nine-year promissory note providing for interest-only annual payments at an annual rate of 1.94% and a balloon payment of the outstanding balance at the end of the note term. The couple could gift the child the amount necessary to pay the current annual interest payments ($9,700) without completely consuming their annual gift-tax exclusions (2 x $13,000 = $26,000). The adult child could use the loan proceeds to acquire a home, invest in a business or even purchase life insurance on the parents' lives. At the end of the nine-year term, the child would either pay the principal back to the parents or give a new note to the parents with interest payable at the then-current applicable federal rate.

Because every family is different, and because we live in a time of constant change, it's important to consult with your tax advisor on the most appropriate wealth-transfer strategy for your objectives and needs—and for more insights on how interest rates and other changes factor into your choices. This is an important time to be working closely with your Financial Advisor, who can work with you and your tax advisor to help ensure that your chosen strategy is an efficient one in the context of your overall comprehensive wealth plan. The Section 7520 rate changes monthly. Please contact us for the most current rate. ■

Recapitalizing Your Business: An Alternative to Selling

For the business owner looking to “take some chips off the table” while still remaining involved in their company, a recapitalization can offer an attractive alternative to selling the business outright.

A recapitalization allows you to sell a portion of your business now, thereby achieving some immediate liquidity. And with the retained equity, you have the opportunity to continue to participate in any future success of the business. Meanwhile, your new financial partner will team with you and your management group with the intent to boost sales and earnings beyond what you could have accomplished alone. If the company grows and prospers as planned, you then have the opportunity to participate in a second liquidity event in the future.

HOW IT WORKS

A recap is a two-step process. In the first step, the business owner sells a portion (often more than 50%) of their equity to a private equity group. At this time, a significant portion of the value of the company may be realized in cash. But, importantly, the owner retains some of the equity in the business and continues on managing the daily operations of the company.

In the second step (usually several years later), the business is sold outright or taken public in an initial public offering (IPO). At this time the private equity group cashes in on their investment. Also at this time, the private business owner cashes in on his or her remaining ownership in the company. Since this second payout occurs in concert with a sale or IPO after the business has achieved a desired level of growth and value, it has the potential to exceed the first payout.

PROS AND CONS OF A RECAPITALIZATION

A recap can be an attractive liquidity option for private business owners. Although not guaranteed, a properly structured recap can provide several advantages, including: some immediate liquidity; some retained ownership; the benefits of an experienced financial partner; continued operating control of the company; shared risk with the financial partner; and the possibility of a generous future payout.

Despite these strong advantages, there are some potential challenges as well, including: some loss of management control, both operationally and economically; scrutiny of financial results by the private equity group; additional financial risk, especially if the company is highly leveraged in the recapitalization transaction; potential culture/chemistry conflicts with the private equity group; and the risk that the company will not achieve the goals of the recapitalization, including a future liquidity event such as a sale or IPO.

NOT FOR EVERYONE

While recaps can be an attractive option, they are not appropriate for all businesses. Candidates must have consistent earnings in order to service the debt of the transaction, and the owner generally needs to be available to stay with the company for another three to five years after the original sale, and must be willing to work with a business partner.

Furthermore, all companies are not attractive to the private equity community. Investment firms typically seek to partner with successful owners with a proven track record of growth, profits, and ambition, as well as opportunity for expansion.

When considering a private equity investor, business owners are advised to take the time to get to know the firm and its partners prior to completing the transaction. Private equity groups vary substantially in their expectations,

motives, strategy and culture. Because they will have a significant influence on the future of the company, the business owner should carefully choose this investment partner.

Another consideration is the environment for recapitalizations, which can vary from year to year. In considering whether a recap is an appropriate exit strategy for your business, you should take into account the current market conditions.

A recapitalization can be an attractive liquidity option for business owners whose exit goals are aligned with the unique characteristics of such a transaction. There are many aspects to consider, ranging from financial considerations to personal factors. For a more in-depth look at recapitalizations, contact us for the Citi Capital Strategies briefing entitled *Recapitalizing Your Business: It's Not All or Nothing.* ■

Private equity groups are not typically interested in the day-to-day operations of the business, but rather in providing "hands-off support" to management while seeking to achieve significant growth and profitability.

HOW IT WORKS—Step 1

As the owner, you would sell a portion (usually a controlling interest) of your equity to a financial sponsor (private equity group). You then reinvest part of the proceeds back into the company (often on a tax-free basis), thereby retaining some ownership. For illustrative purposes, let's assume a company sells for a total enterprise value of $45 million. In this example, a private equity group invests $9 million in cash and funds another $30 million of the purchase price in new bank debt, for a total investment of $39 million. After paying fees and expenses, the owner receives $37.2 million in cash and maintains $6 million in equity in the company. The owner and his or her management team continue to run the business, while the financial sponsor is typically added to the Board of Directors. The private equity group, in theory a sophisticated and experienced financial partner, provides both financial and operational support to expand the business.

HOW IT WORKS—Step 2

Some years later (typically three to five), the private equity group will seek to realize its investment in the business. At this time, it may consider selling the company outright, or taking it public.

Often referred to as "the second bite of the apple," this second transaction represents another payment opportunity for the owner, who still has a stake in the company. Since this second payout would usually occur when and if the business has achieved a desired level of growth and value, it should exceed the equity contributed by the owner in the original transaction.

Revised Limits on Sales of Restricted Stock

Recent SEC rule changes now make it possible for many holders of restricted stock to sell their shares sooner and with greater ease than ever before.

Unless you are a senior officer or director, or you own a large percentage of a company's stock (i.e., you're an "affiliate"), you can sell your restricted shares after holding them for as little as six months—far sooner than the prior one-year holding period. The rule changes also eliminate other requirements, including the need for a nonaffiliate to file Form 144 with the SEC.

The six-month holding period (which starts when the shares are fully paid for) applies *only* to restricted stock of "reporting" companies (those that are required to file periodic reports with the SEC) that are "current" in those filings (they've filed all the required reports for the last 12 months). For shareholders of nonreporting companies and companies that are not current, the one-year holding period will still apply before the restricted shares can be publicly sold.

A PRIMER ON RULE 144

Before selling shares of stock to the public, a company (also known as an "issuer") must register those shares with the SEC unless an exemption from registration is available. Rule 144 is one such exemption that allows the public resale of *restricted* shares (securities acquired in unregistered, private sales from the issuer or an affiliate of the issuer) and *control* shares (securities held by affiliates of the company, regardless of how the affiliate acquired the shares), providing a number of requirements are met.

If you are an affiliate, the rule changes are less beneficial to you, though you too will have the shorter six-month holding period. Otherwise, Rule 144's prior restrictions will still apply as follows:

- You may sell, in any three-month period, no more than the greater of 1% of the outstanding shares or the average weekly trading volume for the four weeks preceding the sale (if the shares trade on an exchange);
- You may sell only through unsolicited ordinary broker or market-maker transactions; and
- You must file a Form 144 with the SEC (although the filing thresholds have been raised to either 5,000 shares or $50,000 market value in any three-month period, including sales by certain related persons. This is up from 500 shares or $10,000 under the previous Rule 144).

For restricted shares of nonreporting companies that have current public information available, you still have to hold your shares for one year and meet all the above requirements.

GETTING HELP

Holders of restricted and control stock have unique needs. Often, they want to sell shares to improve their portfolio diversification, generate cash or make gifts to family and donations to charity. As long as they follow Rule 144, they can treat restricted and control shares almost as they would any other shares.

If you currently own restricted or control shares, or if you have a concentrated position in your company's stock, we can help you follow Rule 144's requirements. Together with Citi's Executive Financial Services Department, we can assess how you could use your shares for liquidity, asset protection and wealth transfer through loans, sales, trading plans, hedging and gifting—without running afoul of federal securities laws or your company's trading policy. ■

Understanding Our Behavioral Blind Spots

Making the Difficult Choices

Investment decisions are among the most important life choices a person can make. They may determine where your children will be able to go to college, when you'll be able to retire, or what kind of lifestyle you'll enjoy after you retire.

Unfortunately, these are also some of the most difficult choices a person can make. In order to make sound decisions, we need to be aware of our own psychological blind spots. These can lead us to make persistently poor financial choices—errors that over time can do significant damage to our portfolios.

CHAINS OF THOUGHT

Traditional financial theory assumes all investment decisions are made rationally, based on the best available information. In theory, the result is an efficient market—one in which prices accurately reflect fundamentals, such as earnings and interest rates.

However, it's not always easy to reconcile financial theory with financial reality. Investors often appear determined to ignore the fundamentals, both in bidding stock prices up and slamming them back down again.

"In many important ways, real financial markets do not resemble the ones we would imagine if we only read finance textbooks," notes Richard Thaler, a professor at the University of Chicago and a leading behavioral finance researcher.

It's not that investors are totally irrational, Thaler and other researchers argue, but rather that their thinking can be influenced by mental biases. These quirks can lead them to make choices that appear intuitively correct, but produce poor performance:

» **Overconfidence.** Investors generally assume they know more than they actually do. They also tend to remember previous investment decisions in ways that exaggerate their own foresight. This can lead to overly aggressive trading and a reluctance to admit—and correct—mistakes.

> "Some studies have shown that the more investors know about the investment process, the less likely they are to be misled by behavioral biases.

» **Mental Accounting.** Financial experts often advise investors to take their entire portfolio into account when making investment decisions. Yet, many investors unconsciously divide their wealth into separate pots. If they have a big gain, for example, they may think of it as essentially "free" money and take greater risks with it than they would with their "own" money.

» **Anchoring.** Logically, investors should always base their decisions on current prices and expectations, . Instead, they often become fixed on past events, such as the price they paid for a particular stock. Investors will often refuse to sell at a price lower than that—even when it makes more sense to accept their loss and invest their remaining money elsewhere.

» **Framing.** How people view a decision often depends on how their choices are presented. For example, in one study researchers asked participants how much they would be willing to pay to avoid a one-in-a-thousand chance of being killed. The average answer was $1,000. Participants were then asked how much they would demand to accept the same risk. This time, the answers ranged as high as $200,000. From an economic point of view, the two questions were identical, but subjects saw them very differently.

» **Loss Aversion**. In a completely rational market, the risk of loss and the possibility of gain should carry equal weight. However, on average investors place twice as much importance on avoiding a loss as they do on making a gain. In other words, to accept a 50% chance of losing $100, most people will demand at least a 50% chance of earning $200.

THE VALUE OF ADVICE

Are investors doomed to repeat these mistakes? Maybe not. Some studies have shown that the more investors know about the investment process, the less likely they are to be misled by behavioral biases.

This is one reason we encourage investors to develop prudent, long-term investment strategies that take into account their goals and tolerance for risk. While this doesn't guarantee investment success, it can at least reduce the risk of being led astray by behavioral blind spots. That's something even the smartest investor might want to keep in mind. ■

smithbarney.com: Your Financial Life at Your Fingertips

Between work, family, travel and other passions, today's on-the-go lifestyle can be exhilarating. The downside of this fast-paced existence, however, is that it's sometimes difficult to keep up with other areas of your life, especially your personal finances.

To stay on top of your finances in a way that's simple and convenient, consider using **smithbarney.com**, a powerful online tool that is free to you as a valued client of Smith Barney.

smithbarney.com provides immediate access to your financial accounts, allowing you to see how your wealth is working for you, 24 hours a day, seven days a week. Log on to smithbarney.com to do any of the following:

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- Research securities (access fundamental equity research on the hundreds of U.S. companies covered by Smith Barney's research division, along with at least one source of third-party research on those same companies)
- Receive your monthly statement online (and save a tree or two)

You also can customize your own home page, so *you* decide what you see when you log on, which services you want to use and how you prefer to invest, making your online experience as individual as you are.

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