



**KEATS, CONNELLY**  
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## Past Performance Really Is No Predictor of the Future

**T**he statement, “Past performance does not guarantee future results,” appears on all mutual fund literature. Since we see it so often, however, it is easy to ignore. Yet the disclaimer is as pertinent as ever. Simply picking funds that have been on top rarely leads to strong additional gains.

As professional investors, our firm sees new clients who come to us with some strange notions about investing. People can be naive or easily forget lessons of the past. While not relying on past performance seems like a pretty basic caveat, remembering why rear-view-mirror investing is flawed is important, and understanding a professional approach is likely to give you new insight into the benefits of working with us.

**Failure To Repeat.** Consider the results of a January 2007 study by Standard & Poor’s analyzing mutual fund performance during the five-year period that ended Dec. 31, 2006. It showed that good performers one year, often fail to repeat the next year.

The study evaluated large-cap, mid-cap, and small-cap funds, measuring how well each actively-managed fund performed relative to others in its class. To gauge performance, funds were grouped into quartiles. A fund that outperformed three out of four funds in its group would rank in the top 25%, or quartile, while a fund that lagged three out of four would be in the bottom quartile.

Only 13% of large-cap funds ranked in the top two quartiles of that class for

each of the five years. Just 10% of mid-cap funds and 10% of small-cap funds ranked in the top two quartiles of that class for each of the five years.

Researchers then raised the bar to see how many funds ranked in the top quartile



every year for five years. A mere 3% of large-cap pulled this off. Only 2.5% of mid-cap funds and none of the small-cap funds were ranked in the top quartile every year in the five-year period studied.

Of course, just because a particular fund falls out of the top ranks occasionally doesn’t make it a bad investment. But the inability of the vast majority of funds to stay on top underscores the difficulty of choosing a fund based only on its record.

A fund that has done well may have succeeded for a variety of reasons. Maybe it had a great manager, or maybe it got lucky because it happened to be operating in a particularly hospitable environment. In 1999, lots of technology funds had great records. However, investors who jumped into those funds soon wished they hadn’t, after the tech-stock bubble burst. A fund’s long-term record, though it can be helpful in evaluating its future prospects, is only one of numerous factors to consider when selecting funds.

**Selecting Funds.** One way to approach fund selection is to think of it as hiring a new employee. The fund manager you select will work for you, collecting a fee in return for trying to build the value of your investment. And while screening funds is not the same as personal

## Why You Should Avoid Direct Debits

**I**t’s a question you may hear when you swipe your card to make a retail purchase: “credit or debit?”

Which is better? When you choose “credit,” the transaction appears on your monthly credit card statement. With “debit,” retailers take the money straight from your checking account.

Most retailers accept debit cards. They like debit cards because they save on the transaction fees credit card companies charge. As a consumer, however, you may want to avoid debit cards, and not for the reason you may think.

Some people consider it risky to give merchants direct access to their bank accounts, and that’s a legitimate concern. Still, you can dispute a direct debit withdrawal much as you would a credit card charge.

A better reason to avoid direct debits: To earn reward points or miles from your credit card company. Some credit cards, for example, give you a refund—around 5%—for grocery or drug store purchases. Unless you get a similar incentive from a retailer to use the “debit” function, you may want to choose “credit.” Using a debit card also means missing out on “playing the float,” which is the period you have to pay a credit card bill before interest charges kick in.

If you need the discipline of charging only up to what’s in your checking account, a debit card is good. If not, stick with a credit card.

**Bob Keats**  
President

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# Inheriting A Spouse's Estate: Understanding

Nothing can erase the emotional havoc you feel when you lose a spouse. But recent changes in IRS laws may help alleviate financial burdens, and understanding the maze of complicated rules for inheritors could help you feel more at ease about your future. Here are several considerations we can review with you.

## Maximizing retirement benefits.

If you're the beneficiary of your spouse's 401(k), IRA, or other retirement plan, that money is paid directly to you after the death. But keeping it may mean a significant income tax bill. If, instead, you roll over funds to your existing IRA, the money can continue to grow tax-deferred. However, if your spouse had begun taking required minimum distributions (RMDs) from the account—but not during the year he or she died—you'll have to take that RMD before the end of the year.

Another option is to put the money in a new IRA naming your deceased spouse as account owner and you as beneficiary. This may offer extra perks. For instance, if you're not yet 59½, you can withdraw funds without triggering the normal 10% early withdrawal penalty, which doesn't apply to death benefits. Or, if you're older than

your spouse and have started taking RMDs from your own IRA, you can leave funds in the inherited IRA until the end of the year in which your spouse would have turned 70½.

### Regulatory Update

Until recently, taking the RMD the year of a spouse's death meant you surrendered the right to disclaim an IRA. Then came Ruling 2003-36, which says you can take the RMD the year of death and still disclaim some or all of the balance until September 30 of the following year.

If you're financially comfortable, consider disclaiming (forfeiting ownership of) all or part of the IRA to contingent beneficiaries, who may be younger and could get a disproportionate benefit from long-term compounding. For example, if you disclaimed \$100,000 each to your 40-year-old son and 10-year-old granddaughter—and if their only withdrawals were RMDs that continued through their expected lifespans—total pre-tax distributions for the 40-year old could be almost \$794,000, and, for the 10-year-old, more than \$4.6 million, according to data from T. Rowe Price.

### Leveraging trusts' benefits.

Spouses benefit from an unlimited marital deduction that lets you inherit any amount from your spouse estate-

tax free, provided you're a U.S. citizen. Yet your heirs could be on the hook. Trusts you and your spouse set up could relieve their burden, too.

● If you and your spouse established a credit shelter trust (CST), also called a bypass trust, specified assets passed into the trust at his or her death. You can tap these funds to pay health, education, or other expenses. But because the money went into the trust rather than directly to you, your heirs get the benefit of your spouse's estate tax exclusion, an amount all individuals are entitled to shield from estate taxes.

Suppose you and your spouse jointly own \$2 million in assets and your spouse separately has \$2 million. While you can inherit all \$4 million tax free, your children or other beneficiaries may owe taxes after your death. Their tax bill will be reduced by your estate tax exclusion, the size of which depends on when you die. From 2006 through 2008, you can pass on \$2 million tax free, and in 2009, the exclusion rises to \$3.5 million. In 2010, there's no estate tax, but in 2011, the exclusion is scheduled to drop to \$1 million.

A CST is usually structured so that, when the first spouse dies, an amount matching that year's

## With Stock Market Indexes Soaring To New All-Time Highs, An

For stock investors, the world has been looking pretty bright. With several market benchmarks at or near all-time highs, making money looks easy, worries about risk seem remote, and having a written investment policy statement (IPS) may feel like a waste of time and paper. But this is exactly when an IPS is most valuable.

An investment policy statement commits to writing the details of your financial situation—what you want to accomplish, a plan for achieving it, and how much risk you're willing to take to get there. It can save you from your own worst instincts, helping you

resist the temptation to reach too far when times are good or panic when the market plunges. Suppose, for example, that the Nasdaq Composite has had a great run, skyrocketing 15% in the most recent quarter. With your portfolio ahead just 5% during the period, you might feel frustrated, and tempted to grab some of Nasdaq's big gainers to try to catch up. A glance at your IPS, however, would remind you why that's a bad idea. The diversification strategy you've committed to is designed to keep your portfolio on a relatively even keel, with judicious allocations to bonds and dividend-paying blue

chip stocks. It has the potential to produce steady gains over the long haul to fund your financial goals. And though it may not take off during a market surge, it's also less likely to go into free fall when the investment climate gets stormy.

While there's no hard-and-fast format for an investment policy statement, most combine the same basic component parts. First, there's usually an executive summary that lays out where you are now in your investing life. It describes your current portfolio and may include your target asset allocation, how much new money you'll invest each

# IRS Rules And A Maze Of Choices

maximum estate tax exclusion goes into the trust, thus making full use of that spouse's individual exemption. Then, at your death, the trust assets pass tax free to the trust's beneficiaries, while the taxable amount you pass along is reduced by your own exclusion. Without the trust, your kids would benefit from only one exclusion.

● Many types of marital trusts allow your spouse to specify who will receive his or her property after your death while still offering you extra income during your lifetime. If your spouse has children from a prior marriage, for example, he or she may have established a qualified terminal interest property (QTIP) trust to ensure they receive their share of the estate.

Ask your attorney to review with you the language in all trust documents to make sure you understand the terms and the level of support you may receive.

**Slimming down capital gains.** If you sell inherited assets, you may owe capital gains tax. The good news is that under current rules, an asset's value is "stepped up" to the market value at a spouse's death, meaning you'll be taxed only on profits exceeding what the asset was worth when you inherited it. For example,

if you receive stock worth \$5 million, it won't matter that your spouse bought it for \$100,000. You'll still be taxed only on proceeds beyond \$5 million.

But that tax break ends in 2010, along with the estate tax. If you inherit and sell assets that year, your tax bill could be based on the assets' original purchase price. But all inheritors will be able to increase the tax basis of total inherited assets by a maximum of \$1.3 million, and surviving spouses can further inflate the basis by up to \$3 million. So if you inherit that \$5 million stock your spouse purchased for \$100,000, your capital gains will be based on a new tax basis of \$4.4 million (\$100,000 original basis + \$1,300,000 step-up + \$3 million spousal provision).

Property given or transferred to your spouse within three years of his or her death, as well as some foreign investments, won't qualify for the 2010 step-up rules.

**Knowing the rules of property ownership.** If you and your spouse owned property through a joint tenancy with survivorship arrangement—that is, you held property such as real estate, motor vehicles, checking or savings accounts, or government bonds together in equal, undivided shares—you become the

owner of that property at your spouse's death.

Joint tenancy is a common strategy for avoiding probate. But owning assets in this way means you can't preserve your spouse's estate tax exclusion.

Only the final survivor in a joint tenancy contract may dispose of the property through a will. So it's important for you to provide in your will for the entire property to be passed along to specified beneficiaries. Otherwise, it will go to your heirs in accordance with state law.

If you reside in a community property state—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—assets acquired during marriage are divided equally after a spouse's death. Each owner may decide who will inherit his or her share of the assets. Establishing a joint tenancy arrangement in a community property state is possible, but complex. You may be allowed only half the step-up basis when you sell, because you technically own only half the assets.

**Filing your tax return.** You can file a joint return in the year of your spouse's death, unless you remarried during that calendar year, or you could file separately. In addition, if you support a dependent child for whom you can claim a tax exemption, and you haven't remarried, you could file as a "qualifying widow(er)"—equivalent to a joint filer—for two years after your spouse's death.

Be sure to indicate "**Deceased**" across the top of a joint return, along with your spouse's name and date of death. As a surviving spouse, you get an additional \$1,250 deduction.

These are complex rules, and we know this is a challenging time for you. Always feel welcome to contact us about any concerns you may have. ●

## Investment Policy Statement Is Key

month or year, and what index benchmarks are used to gauge your progress. The executive summary also considers risk, often in terms of how much of a loss you could tolerate during specified time periods.

Next, your IPS may detail your **investment objectives**—for example, that you and your spouse plan to retire in 15 years, and you'll need income of \$200,000 a year, inflation adjusted, for three decades. Your **investment philosophy** sets out your investing rules to live by. How do you feel about risk, diversification, frequency of trading, investment costs, and taxes? Answering these questions

in a formal IPS provides a philosophical underpinning for specific **investment selection criteria** that translate your beliefs into action. Finally, the IPS may outline **monitoring procedures** for gauging your progress.

If you don't already have an investment policy statement, please let us help you create one. Simply going through the process can be invaluable; answering our questions about your goals and risk tolerance may focus your thinking in a new, beneficial way. And with your IPS in hand, we'll know how to serve your needs whatever the market climate. ●

# Consider Buying Instead Of Leasing A Nice Car

**W**ondering whether to lease or buy your next car? There are a lot of variables to factor into your decision—and not all of them are strictly financial.

**Why lease?** The conventional wisdom says leasing allows you to drive the industry's newest, hottest cars. (BMW recently led the list of the most requested vehicles at [LeaseCompare.com](http://LeaseCompare.com).) You can have a new car for a lower monthly payment, and you could save or invest the difference. Moreover, if you use the vehicle for work, writing off a lease payment may be easier than the calculations for a vehicle you own. It's noteworthy, too, that car leases don't appear on your record as credit debt.

Basically, you rent the car for the duration of the lease, and pay only for depreciation. For example, if you lease a \$50,000 car that will have an estimated resale value of \$35,000 after two years, you're responsible for the \$15,000 difference (the depreciation) along with finance charges and fees.

Because leased vehicles tend to

be new or late model, you shouldn't face hefty repair bills. However, most leases cover only the first 12,000 to 15,000 miles per year; drive farther, and for each additional mile you'll owe as much as 25 cents when the lease ends. If you drive a lot—say, 20,000 miles or more each year—any benefit of a lease's lower payments is likely to be outweighed by mileage charges and you're probably better off buying. Breaking the lease—that is, returning the car early—comes at a great cost. And when you turn in the car, you'll be assessed for any wear and tear that's out of the ordinary.

**Why buy?** Again according to the conventional wisdom, the overarching benefit of buying is financial. When a lease expires, you have to turn in the car or purchase it for its residual value. If you buy at the outset (or finance the purchase), the car's yours, and when interest rates are low, that's generally cheaper than leasing. And it's more flexible—you can sell or trade the vehicle whenever you want.

But what if your car seldom makes it out of the garage? You have

a short commute to work, or to the train station. Yet you like to drive, and enjoy the thrill of piloting a high-end sports or luxury model. You could lease an expensive car, turn it in when the lease expires, and replace it with another leased vehicle, guaranteeing you'll always have a car payment. Buying could make more sense. Once any loan is paid off, no more payments, and your lightly driven favorite ought to last for years. And if you sell or trade, you should get a good price.

You may also want to consider buying a car that's just a year old or two. Much of the depreciation in a car's value occurs in its first year. So buying an almost new car often makes good financial sense.

**The bottom line?** The lease versus buy decision is as much a lifestyle choice as a financial one. You can run the numbers for yourself by using a calculator on the Web. For more details, including financial calculators, visit: [www.cars.com](http://www.cars.com), [www.leaseguide.com](http://www.leaseguide.com), or [www.edmunds.com](http://www.edmunds.com). Or call and ask us for assistance. ●

## Past Performance

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interviews with managers, exploring a manager's areas of specialization, track record, and investment style is informative. Some other factors we consider include:

- Whether the fund manager deviated from the fund's strategy—for example, if it's a government bond fund, does the manager sometimes buy riskier high-yield bonds or growth stocks to boost returns? How much of the fund's portfolio was involved?

- How much money is flowing into the fund? Often, funds get popular after they've been successful. But a flood of new money can overwhelm a manager and cause performance to drag.

- How has the manager responded when the fund's investments are out of favor? Has he managed to eke out a positive return even during tough times?

Or is his style to stay fully invested? This could affect your asset allocation and needs to be anticipated.

- Other factors to consider include the fund's expense ratio, tax efficiency, trading history, the team surrounding the fund manager, and the fund company's reputation.

Past performance is a factor in the selection process, but primarily as a tool for evaluating the manager. Consistent returns, for example, could indicate a steady management style that does not chase fads. Rather than considering returns alone, it helps to compare the fund's track record with an appropriate benchmark. How did the fund performance stack up against an index of large-company stocks, for instance?

Fund selection is also influenced by economic factors or the prospects of a

particular sector. While market timing has been shown by many studies as ineffective, looking for investments that are out of favor or asset classes that are selling at prices below their historical valuation could present opportunities.

The bottom line is that a fund's past performance doesn't ensure returns in the future. A manager's track record, consistency, methodology, and experience must be considered, but these factors are only part of the equation. Fund selection depends on your personal needs, tax situation, and other portfolio holdings. Rather than just looking into a rear-view-mirror at past performance, the investment outlook and your personal factors will probably be more important in selecting the funds right for you.

**Always read a fund's prospectus before investing.**