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Harris myCFO® | Turning Downside Equity Market Volatility into Opportunity

Background

In the fall of 2010 our whitepaper, ***“Managing Investment Strategy and Planning in an Era of Increased Market Volatility”*** (available at www.harrismycfo.com) noted that the heightened volatility we experienced over the last decade (the worst since the great depression) was likely to emerge as the new framework for investment decision-making.

At the time, we pointed to high unemployment, unconventional monetary policy and unsustainable fiscal projections as a few examples of the unprecedented set of issues ready to re-ignite volatility. The U.S. Government’s dysfunction in addressing the debt ceiling and S&P’s subsequent downgrade of U.S. debt along with sovereign debt challenges in Europe have provided the spark—equity markets are down double digits from the 2011 peak and markets need to rally over 30% to regain their all-time highs.

While our paper offered four recommendations in developing sound investment strategy that integrates income and estate tax planning in an environment of higher volatility, we think it is now an opportune time to focus on one in particular – turning volatility into opportunity.

Turning volatility into opportunity

The volatility we have experienced recently has resulted in lower equity prices and, at the same time, driven interest rates to all time lows. Opportunities to create additional wealth and reduce risk by implementing a variety of investment and planning strategies include:

Diversifying low basis, concentrated portfolio holdings

Concentrated portfolio holdings, like a single stock that comprises a meaningful allocation within a portfolio, can present investors with an inferior risk/reward profile. Although concentration has made some investors wealthy, outsized returns often come with significant volatility. For the investor who has shifted her focus from wealth creation to wealth preservation, the return potential of a concentrated stock position may not be worth the risk. In fact, volatility can operate as a drag on returns. For example, if given two assets with the same average return but different standard deviations (a measure of volatility), the asset with the lowest volatility produces the highest compound return over time.

For an investor who wishes to reduce the risk of a concentrated holding, one option is to sell the asset outright and invest proceeds in a diversified portfolio. The hesitation in doing so is often the tax obligation resulting from sale. Despite the fact that paying tax reduces wealth in the short-term, there are two reasons to think about doing so in a time of downside volatility. First, as noted above, a higher compounded return may be achieved through a diversified portfolio offsetting taxes incurred and more, and second, depressed asset prices reduce built-in gains and related taxes shortening the time horizon to receive the benefits of such a transaction. Ultimately, if paying taxes now is not an option, and you are charitably inclined, then a charitable remainder trust is worthy of consideration as such a structure may allow you to diversify without paying tax.



Transferring wealth with tax efficient strategies

Reduced asset values and low interest rates can provide more bang for the buck in transferring wealth assuming that values will recover in the future. This wealth transference can take the form of an outright gift, sale, and/or the creation of (or as a supplement to) a trust.

Depressed equity values and low interest rates make grantor retained annuity trusts (GRATS), and other strategies especially attractive planning tools in today's volatile environment.

Reducing income taxes by "harvesting" tax losses

Provided that an investor has a diversified portfolio, it invariably includes assets that have declined in value to a point of producing losses (realized and unrealized), as well as gains. A period of downside volatility is a good time for a portfolio review to trigger a realization of losses to offset portfolio gains. Harvesting tax losses in this manner may reduce an investors' overall tax burden and provide a tax benefit that, if unused immediately, can be carried over to future years to offset future gains when markets recover and assets appreciate.

Controlling risk through portfolio rebalancing

"Buying low and selling high" is used frequently as short hand in the investment world. It describes a strategy that if perfected and repeated often would lead to significant wealth. A policy of rebalancing to an investor's asset allocation targets effectively executes on this strategy and produces the added benefit of maintaining an agreed upon balance between risk and return. A period of high volatility requires frequent review and monitoring of an investor's asset allocation to realize rebalancing opportunities.

Why Acting Now Is a Good Strategy

Although we believe heightened volatility is likely to continue over the next several quarters at least and quite possibly longer depending on some of the contributing factors mentioned earlier, periods of downside volatility provide brief windows of opportunity in which to take action. It's best if planning is done as early on in these windows as possible so you can make the most of the opportunities they present.

In addition, we believe that there is a significant risk that income and estate tax rates, exemptions, and other strategy provisions will become less advantageous by 2012. Downside volatility coupled with relatively advantageous tax and wealth transfer provisions make this time an opportune one to take action.

For more information, contact your Harris myCFO advisor or Craig Rawlins at (312) 461-3764



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