BESSEMER TRUST

A Closer Look

Why You Should Review Your Family's Asset Allocation Today

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In Brief

- **Given the length of the economic expansion and the aging — and increasingly jittery — bull market, now is an ideal time to take a thorough financial inventory and review your asset allocation.**
- **Aside from the financial markets' inevitable changes, your family's circumstances and goals are likely to change over time as well, so it is important to revisit your asset allocation and investment plan periodically to ensure they still make sense.**
- **Along with an examination of your overall allocation, a thorough review should include an analysis of each account and broader objectives.**

The U.S. economic expansion just passed the 10-year milestone, making the current expansion the longest on record. Corporate profits have surged, and margins remain high. Interest rates and inflation are low, and with a 3.7% unemployment rate, the U.S. consumer is in good shape — which is especially important in a country where 70% of GDP is driven by consumption. Since the market bottomed in March 2009, global stocks have advanced nearly 250% cumulatively, or 13% annualized.

In addition to the normal worries that come with any aging bull market, there are real economic headwinds and vulnerabilities today, including a trade war with the potential for escalating tariffs, recent declines in business confidence, and a general slowdown in the global economy. Investors are hoping for more aggressive monetary policy, which could end up disappointing them. And global populism, which can be a destabilizing force, is still on the rise. Over the last couple of years, and including earlier this month, Bessemer has taken incremental steps to reduce risk in client portfolios. At this point in the economic cycle, we are more concerned about the potential downside in equity markets than excited by the upside. Client portfolios are now positioned with slightly less risk when compared to benchmarks.

As a reminder, Bessemer makes tactical adjustments to a client's long-term, or strategic, asset allocation. These adjustments are driven by Bessemer's centralized investment policy group and its outlook for the risk and return of different asset classes. As these changes are always made relative to a specific strategic allocation (which can be different from client to client), this highlights the importance of developing the right strategic asset allocation in the first place.

Developing a Long-Term Strategic Asset Allocation

Financial markets are constantly in flux, and so too are circumstances within any given family. Spending needs, ability to tolerate risk, and long-term goals all may change. Even if financial markets were static, which they clearly aren't, it would be wise for a family to revisit its asset allocation and investment plan at least every couple of years to ensure it meets the family's objectives.

Exhibit 1: Sample Family Financial Statement[1]

Type of Account	$ Millions	Asset Allocation (Stocks/Bonds/ Alternatives)
G1 Taxable Account	15	55/35/10
G1 Retirement Account	5	80/20/0
G2 Trust Account	7	60/20/20
Charitable Account	3	80/20/0
Total	30	63/27/10

G1 refers to first generation, and G2 refers to second generation.

Overall asset allocation. A useful starting point is to assemble a simple balance sheet that includes all major investment assets owned by a family (Exhibit 1). Both taxable assets and retirement assets should be included, as well as trusts set up for future generations and assets designated for charity. Reviewing all family assets on one piece of paper provides a valuable perspective and a good beginning framework.

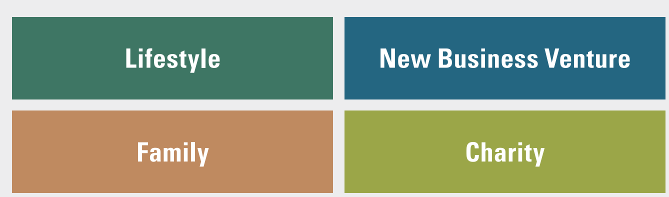
Factoring in the size and asset allocation of each type of account, the family is able to see that their overall mix of assets is 63% stocks, 27% bonds, and 10% alternatives. Even though the trust and charitable accounts are outside of the estate of the senior generation (G1), their positioning may be very important to G1. For example, G1 may be much more comfortable with a larger tilt to bonds in their taxable account knowing that the accounts set aside for their kids (G2) and charity have a focus on higher-return, higher-risk assets. The family must look at all of their accounts holistically to gain this important perspective.

Asset allocation of each account. After the overall exposures have been identified and contemplated, a logical next step is to drill down and see how the exposures look in each of the different accounts. Each account comes with its own history and may have a unique purpose in a family's overall plan. No two accounts are the same — they may have different tax treatment, owners, beneficiaries, time horizons, etc. What may be right for one account might not make any sense in another. Allocations for each account should be scrutinized individually, and also relatively (see Example: Taxable vs. Charitable Allocation on page 3), asking the question — "Are we taking risk in the appropriate account?" The taxability of each account and its time horizon are also very important factors. This is also a good time to make sure titling and beneficiary designations are current and in line with the most recent estate plan. Out-of-date beneficiary designations are a very common mistake and are easy to avoid.

Asset allocation for each goal. It is helpful to step back and think about the question — "I have accumulated a lot of wealth — now what is the purpose of this money?" The sooner this is done, the better.

While contemplating this question can be a long, introspective, and rewarding exercise, in the end many clients articulate a handful of common goals for their wealth (Exhibit 2). The most common cited for at least part of the wealth is to meet G1's spending needs for their lifetimes. Other important goals include giving away money now to family or charity, or setting money aside to do that in the future. There may also be a new business idea or venture that G1 would like to fund at some point soon.

Exhibit 2: Common Goals for Wealth



[1] For purposes of simplicity, our example contains only four different types of accounts. Typically, clients have many more, which may include revocable and irrevocable trusts, grantor and non-grantor trusts, GRATs, deferred compensation accounts, Roth IRAs, donor-advised funds, private foundations, and split interest charitable trusts, to name a few. The same framework applies, but it just gets more complicated.

Example: Taxable vs. Charitable Allocation

What is the right allocation for the taxable account, and should it have a higher allocation to bonds as compared to the charitable account? Even though the answer is usually "it depends," asking the question and thinking about each investor's unique circumstances will lead on the path to the right answer.

A taxable account is often the primary source of spending for the senior generation. If the spending rate is low, an investor may be comfortable with a significant commitment to stocks and other higher-returning assets, knowing that even in a bear market, the draw on the account will likely remain modest.

Other investors may be spending a bigger part of their account every year, and because of this, they might not want too much short-term risk.[2] A high spending rate coupled with a bear market might be tough to recover from.

Important questions need to be answered on the charitable side as well:

- Is the entity subject to tax? Although charitable entities are usually tax exempt, there may be some tax considerations including the unrelated business income tax (UBIT) for charities that own operating businesses, private equity, or hedge funds.
- Is the entity a private foundation, which has a required payout of at least 5%?
- What is the time horizon for the charitable assets? Some charitable entities have the goal of perpetuity.
- For the ultimate charitable beneficiaries, how important is a consistent distribution from year to year? Most charitable accounts have long horizons, and beneficiaries are often able to tolerate fluctuations in the gifts they receive, suggesting an allocation tilted more toward stocks. However, this is not a given and depends on the specific circumstances of each charitable entity.

There is more than one right answer; it is the process that is important to follow.

A final way to think about asset allocation is goal by goal. Often, two or more accounts exist to support a single goal, and these accounts should be viewed in tandem. The example on page 4, Allocation by Goal, illustrates this concept.

Now Is a Good Time to Review Your Investment Plan

Engaging in thoughtful planning is always a useful exercise, and now might be a better time than most. More than 10 years into the current economic cycle, with markets still roaring ahead but risks building, taking a financial inventory makes good sense.

There is no one right way to develop a family's asset allocation and investment plan. Financial markets and family dynamics change over time, and both are important considerations. Looking at your family's total assets and exposures on one page can be a simple but eye-opening experience. With that as a useful first step, accounts should also be scrutinized individually and relative to their ultimate purpose or goal in your overall plan. In the end, much of the wealth created will either help support G1's lifestyle or be targeted to family and charitable goals. This process improves the odds that the money is there for its intended purpose.

[2] On the flip side, an investor who is spending a large percentage of his or her account might need higher exposure to stocks and other riskier assets over the long term to improve the odds of having enough in assets down the road. Asset allocation involves thinking through both short-term risks (market volatility) and longer-term risks (depletion of capital). The answer also depends on whether the retirement assets are there to supplement G1's spending needs or if they are being targeted for G2 or charity.

Example: Allocation by Goal

Erick and Suzanne are in their 60s and have the assets outlined in Exhibit 1. Let's assume at first that they expect outside income from boards and consulting and only plan to draw $200,000 per year from their taxable portfolio. Clearly some part of their taxable portfolio is necessary to support this spending with a high degree of confidence for as long as they are likely to be alive. But what about the retirement assets — are they necessary to help the family meet their spending goal of $200,000 per year? Our analysis would suggest they are not. When we run an Implication Model[3] based on this specific fact pattern, the odds of depleting the taxable account alone over the next 30 years are less than 2%. The bottom line is that $15 million in taxable assets is more than enough to sustain the family's lifestyle.

So then, the question becomes, what is the purpose of the $5 million retirement account? Is it money targeted for G2? Or would they rather leave those assets to charity (which very well could make sense when thinking about possible income and estate taxes)? Different answers will have different implications for the asset allocation of the retirement account. Oftentimes assets targeted for charity or the next generation have a higher stock weighting due to the longer investment horizon, but the key point is this: The retirement account should be allocated with the objectives of the ultimate beneficiary in mind — be it family or charity — and not based on the age or time horizon of G1. (As an aside, there are pending proposals in Congress that would limit how long a retirement account could last beyond G1.)

Now what if Erick and Suzanne were consuming $700,000 per year from their assets and not $200,000 (see Exhibit 3)? In this case, the retirement assets would be a pivotal part of their nest egg to support their lifestyle goal. The higher spending burden means the likelihood of depleting the taxable account is now uncomfortably high — 62%, in our estimation. As such, the retirement account should be thought of as similar to the taxable account. Of course, the income tax differences should be factored into the final recommendation, but the retirement assets should be allocated based on the investment horizon and risk tolerance of Erick and Suzanne, not G2 or charity.[4]

Exhibit 3: Focus on Retirement Account

	Spending $200,000	**Spending $700,000**
Purpose of Retirement Account	G2 or charity	Support spending for G1
Asset Allocation	Based on G2 or charity investment horizon and risk tolerance	More similar to taxable account, factoring in income tax differences with taxable vs. retirement accounts

[3] Bessemer Trust's Implication Model is a proprietary tool designed to help clients make better-informed asset allocation and spending decisions by assessing the inherent trade-offs. Taking into consideration each client's unique circumstances, the analytical model simulates capital market returns, quantifying the probabilities of achieving different goals.

[4] If retirement assets and taxable assets are both likely to be used to meet the spending needs of G1, the income-tax differences and time horizon are the key factors in differentiating the asset allocation between the two. Since the retirement assets do not face tax until the assets are distributed, they can be a good place to hold tax-inefficient assets like taxable bonds or hedge funds, if appropriate. A full analysis of the asset "location" differences between taxable and retirement assets is beyond the scope of this note. As an aside, most investors will be better off consuming their taxable accounts first and only taking the required minimum distributions from retirement accounts. This allows the bulk of the money to grow tax deferred as long as possible.

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