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Asset allocation basics

One approach to understanding investing risk is to array categories of investments in a pyramid. At the base, one finds the safest investments — savings accounts, certificates of deposit, money market funds. The next layer, which might include blue-chip stocks, Treasury bonds and municipal bonds, is somewhat riskier. Then comes a layer with corporate bonds, growth stocks and rental real estate. At the top of the pyramid, with the greatest risks, are junk bonds, speculative stocks and options trading.

Actually, it's not that simple. As researchers learn more about investment risk, some have found two shortcomings in the pyramid concept:

- For short-term investors, the pyramid probably understates risk.
- For long-term investors, it may misstate the risk of various investment classes.

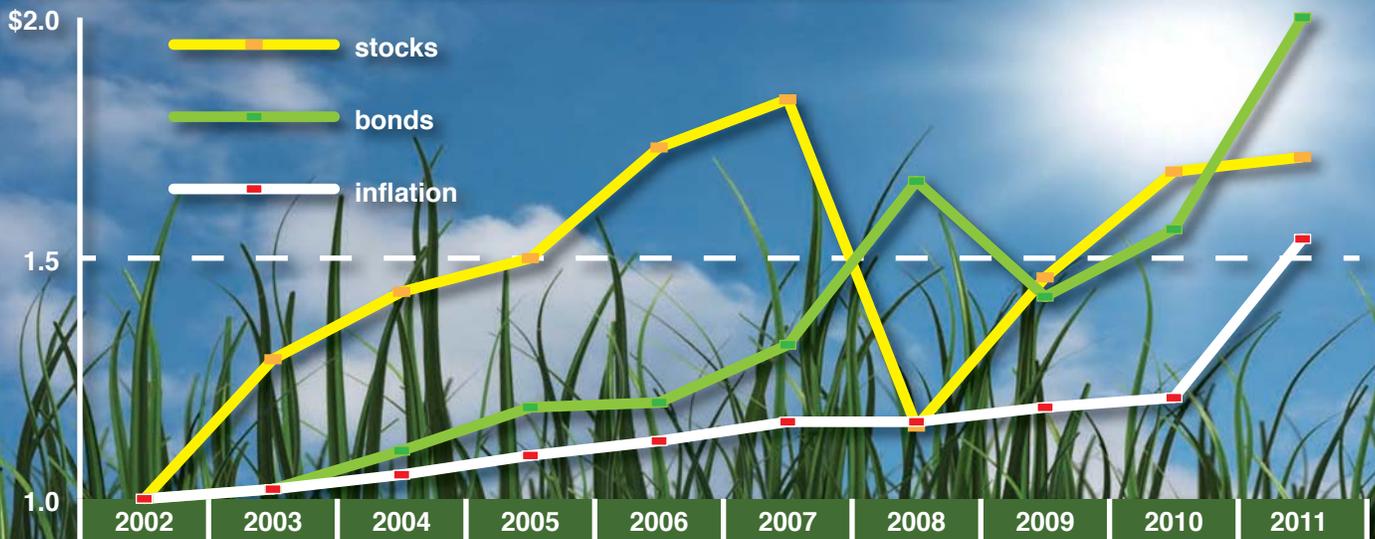
Why should these shortcomings concern you? Unless you see risks clearly, you can't make an accurate risk assessment for your own investment program.

Risks in the short term

For short-term investors — people who will need to sell in a few years — even blue-chip stocks are more than slightly risky. So are long-term bonds, even Treasury bonds. Here's why:

- Stock prices can plummet 20%, 30% or more in the course of a year. They fell 38% in 2008. The Standard & Poor's 500-stock index measures the performance of shares in 500 major, large-capitalization companies. By that measure, stock produced annual losses, even with dividends reinvested, four times in the last 15 years.
- Long-term bonds can also be surprisingly risky for investors with relatively short time horizons — those who may have to sell the bond before maturity. As interest

A difficult decade for investors • GROWTH OF \$1.00



Source: M.A. Co. Data: Ibbotson® SBBI® 2012 Classic Yearbook

Balance over the decades



Historically, bonds have provided ballast for a portfolio, smoothing out volatility over time. Some of the potential upside of equities is sacrificed for the sake of lowering risk. This pattern has been broken recently, with bonds frequently outperforming stocks. A balanced approach remains best for many investors.

Compound Annual Rate of Return by Decade

Portfolio makeup	1980s	1990s	2000s	2002-2011
100% stocks	17.6%	18.2%	-0.9%	2.9%
70% stocks, 30% bonds	16.5%	15.5%	2.1%	5.2%
50% stocks, 50% bonds	15.5%	13.6%	3.9%	6.5%
30% stocks, 70% bonds	14.5%	11.7%	5.5%	7.7%
100% bonds	12.6%	8.8%	7.7%	8.9%

Source: M.A. Co. Data: Ibbotson® SBBI® 2012 Classic Yearbook

Asset allocation . . . continued

rates rise, the value of an existing bond must fall. In 2009, for example, long-term government bonds had a total return of -14.9%. See “A difficult decade for investors” for the record of the last ten years.

Adding time and balance to the analysis

The longer one's time horizon, the lower these investment risks become. There is no 20-year period in the past 86 years, for example, in which stocks have posted an overall negative return — including those in which the Great Depression occurred. Despite the bad years at the start of this century, when the Internet bubble popped, the S&P 500 returned 2.9%, compounded annually for the past ten years, and 7.8% over the past 20 years.

What we bring to the table

We'd like to be able to say that we have a magical solution to every investor's needs right now. We don't. No one does. And you probably already understand that.

What we do have are trust and investment services that are *objective* and *personalized*.

Objective. Our investment advice reflects the same high standards that guide our work as trustee. We don't deal in exotic financial engineering; we invest in instruments that ordinary people have heard of and can understand. To remove any chance of conflict between our organization's interests and our client's interests, we do not work on commission. Instead, we charge moderate annual fees, based on the market value of our clients' holdings. When the dollar value of a client's account grows over the years, we receive more dollars of compensation. If a client's account shrinks in value, so does our reward.

Personalized. As we see it, our business is not simply managing investment programs. Our business is helping people — helping our clients achieve their financial goals. We've learned that serious investors can't settle for a “one size fits all” approach. We see each of our clients as possessing a unique mix of financial facts, family circumstances and personal goals. The better we understand each client's unique situation, including his or her tax picture, the better our chances of retaining the client's business for many years to come.

The other key factor to take into account is that investments don't move up or down in lockstep. That's what makes portfolio diversification so important — when some asset classes are doing poorly, others may be doing well.

Balance the investment classes

The best way to moderate the impact of stock and bond volatility is to own some of each. As we said, asset prices do not move up or down in lockstep. When stocks rise, bonds may fall. Or at other times, bonds also may rise when stocks do. The movements of each asset class can be mathematically correlated to the movements of the other classes. *Portfolio optimization* involves the application of these relationships to the investor's holdings.

An *asset allocation plan* is a program of disciplined portfolio diversification. To oversimplify, there are three steps:

- Determine the expected return from each asset category — stocks, bonds and cash. Expected returns may be determined for subcategories as well — small company stocks, corporate bonds, intermediate maturities and so on.
- Decide which combination of these asset classes offers the best return for a given level of acceptable risk.
- Given target allocations, select investments within each class for the portfolio.

Expected returns need to be linked to the investor's time horizon. Longer time horizons give the investor more time to recover from bad years, more chances to be in the market for good years. See “Balance over the decades” for a simplified example of various portfolios consisting of just large company stocks and long-term government bonds.

An asset allocation plan must take into account an investor's goals, time frames and risk tolerance. Sound portfolio design and management are, frankly, jobs for professionals. This is an area where we would be pleased to be of service to you and your family.

Can we tell you more?

Would you like to know more about our services for investors? Call on us! We look forward to discussing your requirements in detail, in person. □

The limits of adult adoption

Wilbert (“Bill”) and Genevieve (“Vieve”) Gore founded W. L. Gore and Associates, Inc., in 1958. The privately held manufacturing company is headquartered in Newark, Delaware, and best known for its GORE-TEX® fabric. In 1962, the Gores began a program of giving shares of their company to their five children, a portion of which went to an irrevocable trust. By 1965, each child had 3,900 shares of stock.

In the early 1970s, the couple established an estate plan. It called for providing an equal number of shares to each of their grandchildren, but there was an important catch. The grandchildren would be assumed to have inherited equally the shares that had been given to their parents, whether or not that actually occurred.

Four of the children had four children each. The fifth child, Susan, had only three children. The way the numbers worked out, each grandchild had a target inheritance of 1,395 shares. Susan’s three children would be credited with 1,300 each as their share of her holdings, and so they would get an additional 95 shares. Each of the other grandchildren, because they had one more sibling, would be credited with only 975 shares from the parent, and so they would inherit 420 shares. Susan’s children were not happy with this result, especially as Susan already had sold most of her shares.

An assault on an estate plan

Susan and her children asked for a change in the estate plan, but the other beneficiaries and Vieve Gore refused to make any change. (Wilbert had died by then.) Susan then had the idea of adopting her own granddaughter, so as to equalize the distribution. Her ex-husband, Jan, objected to that idea and joked that he be the adoptee instead.

That is exactly what happened. Jan promised that he would not personally benefit financially from the arrangement, asking only that he be protected from any costs. The adop-

tion was carried out under the laws of Wyoming, when Jan was 65, and he became the legal child of his ex-wife.

Once Jan’s status changed, he had a change of heart and decided that he wanted to receive the shares due to the other grandchildren after all. Susan began to investigate the possibility of nullifying the adoption, but then Vieve died in 2005, bringing matters to a head.

A mediation was conducted in 2007, and it was agreed to by some members of the family. However, not all of the beneficiaries signed off on it, and no one represented the interests of the great-grandchildren.

In the subsequent litigation, Jan was ruled ineligible to inherit under the doctrine of “unclean hands.” Furthermore, he could not be considered a grandchild for purposes of determining the property distribution, regardless of his legal status. It is clear that Bill and Vieve intended to benefit only such persons as had a normal parent-child relationship with their own children. In May of this

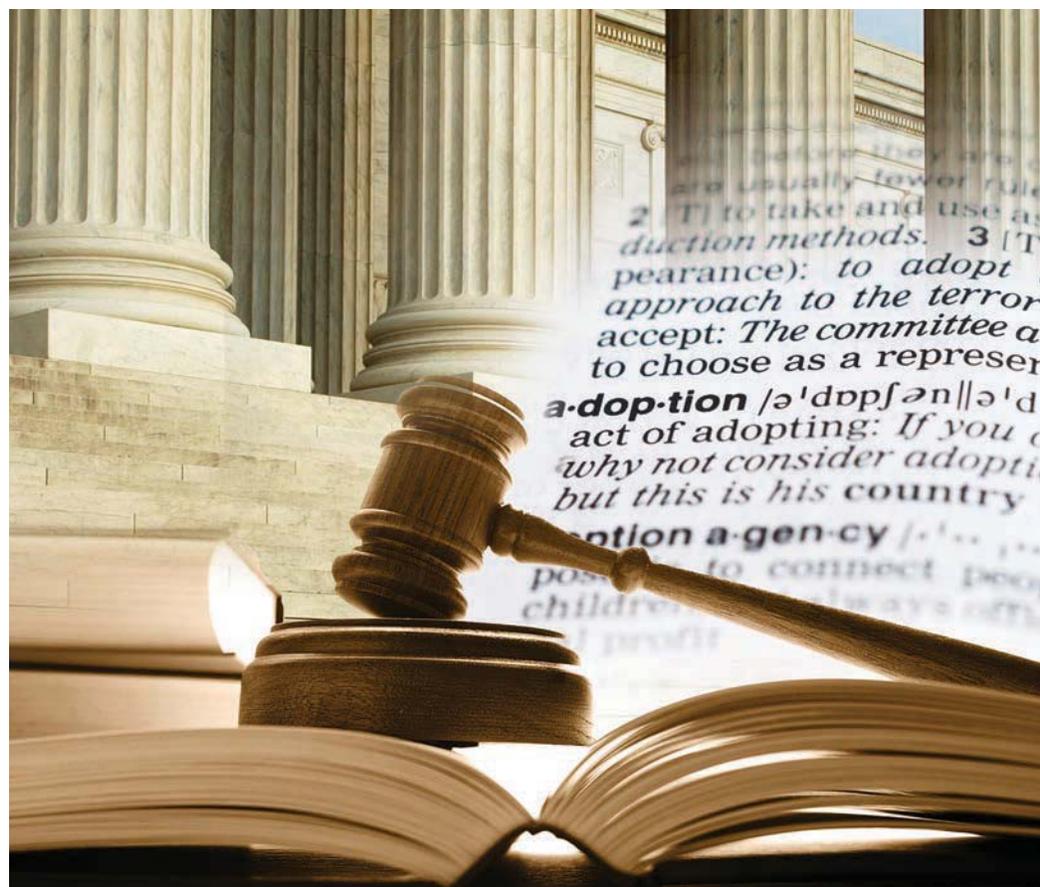
year, the Delaware Supreme Court affirmed the result.

Observations

The equalization formula that the Gores used for their grandchildren may sound very fair from their point of view. However, Susan’s children understandably feel that they will be getting a reduced share simply because their mother didn’t have another child, a decision that they were no part of. Their feeling of disparate treatment may be exacerbated by the fact that they won’t inherit the shares that are being counted against them, because most of those shares have been sold.

This estate plan was implemented via a trust plan, one that was well drafted and stood the test of time.

The court decision does not state the value of company shares at the heart of this fight, but the company reportedly has \$3 billion in annual revenue. Somehow, one would hope that there could be enough to satisfy everyone. □



“Death puts”

Where can retirees find higher income yields? Long-term corporate bonds, farther along the yield curve. The catch? In five or ten years, when we're experiencing an economic boom, higher interest rates and inflation, the market value of today's 30-year bonds will plunge. That means a reduced inheritance for a surviving spouse or other heir.

One solution to consider is a feature available on some bonds called a “survivor's option,” an “estate-feature put” or, more informally, a “death put.” A bond with this provision may be redeemed at the holder's death for its full face value, regardless of its market value at that time.

Death puts have been around since the 1990s, and they are found on some corporate bonds and some certificates of deposit. Some bonds have a holding period, typically six or 12 months, before the death put may be used. The feature may reduce the bond's interest payments by roughly 0.125% per year.

Bonds with death puts have been growing in popularity. According to *The Wall Street Journal*, about \$12 billion in such notes have been issued in each of the past three years, and such issuance could increase by 10% in 2012. Such bonds recently have had yields of around 5%. CDs with death puts, which also carry FDIC insurance, have had yields of around 3%, depending upon the maturity date.

Whether bonds with death put features will be right for you and your family will be determined by many factors. Such bonds are not the best choice for everyone. See your estate planning and financial advisors to learn more about the role that such securities might play in your portfolio. □

Quotable

“The actuary is supposedly going to lower the assumed reinvestment rate from an absolutely hysterical, laughable 8 percent to a totally indefensible 7 or 7.5 percent. If I can give you one piece of financial advice: If somebody offers you a guaranteed 7% on your money for the rest of your life, you take it and just make sure the guy's name is not Madoff.”

—New York City Mayor Michael Bloomberg, responding to a proposal by the city's chief actuary to lower the assumed rate of return for the city's five pension funds to 7% from 8%



Would you like a second opinion on your investment strategy?

Are you a do-it-yourselfer when it comes to portfolio management? The challenges for keeping up with today's financial markets can be overwhelming.

If you need another player on your investment management team, call on us!

Doug Oldaker, J.D.
Executive Vice President
402-221-0122
DOldaker@snbomaha.com

Brent Boyce
Trust Investment Officer
402-221-0162
BBoyce@snbomaha.com

Monte Schatz, J.D.
Trust Manager
402-221-0120
MSchatz@snbomaha.com

Kevin Poots
Trust Officer
402-221-0121
KPoots@snbomaha.com

Sarah Lierman, J.D.
Trust Officer
402-221-0140
SLierman@snbomaha

Jim Kerkhove, J.D.
Employee Benefits Trust Officer
402-221-0163
JKerkhove@snbomaha.com



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