



Northern Trust  
**Family Office Association**

**FOA Fall Global Summit**

*Wealth Transfer Trends in the New Decade*

R. Hugh Magill  
Executive Vice President & Chief Fiduciary Officer  
November 4<sup>th</sup>, 2010

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[northerntrust.com](http://northerntrust.com)



# Northern Trust – A Unique Business Focus



121 year history – *undiluted by merger or acquisition* – a partner you can trust

Assets under custody  
**\$3.9 trillion**

Assets under management  
**\$657 billion**

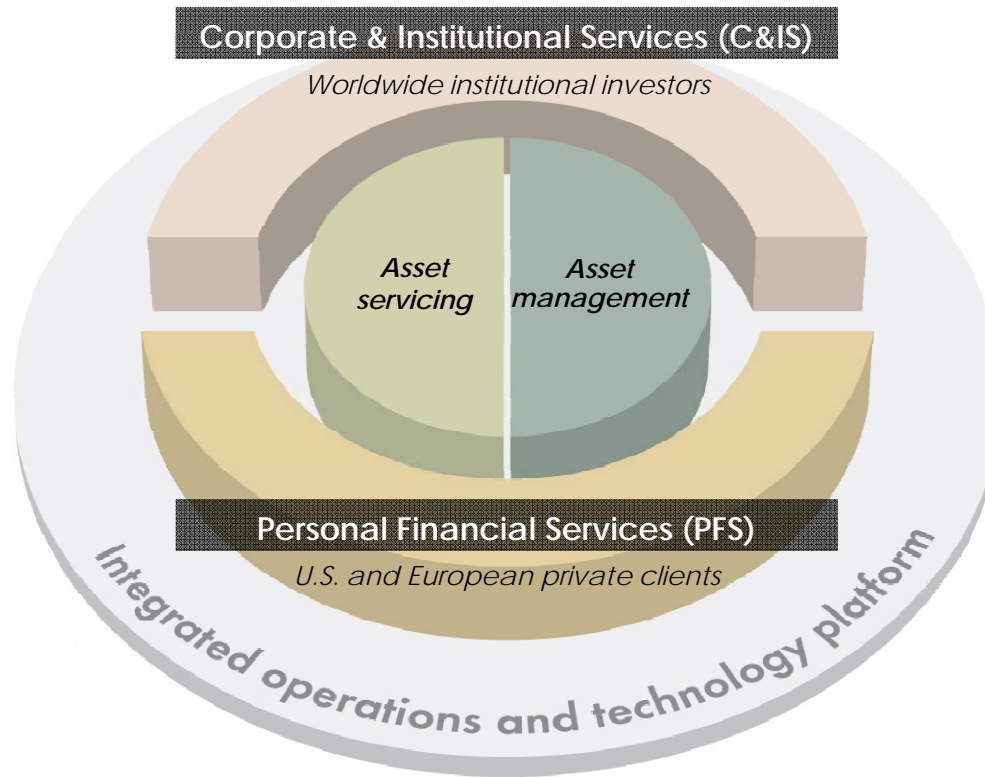
Personal Assets under custody  
**\$349 billion**

Balance Sheet Assets  
**\$74.7 billion**

Ticker Symbol  
**NTRS (Nasdaq)**

As of September 30, 2010

Source: Northern Trust (updated quarterly)



## Businesses Northern Trust is NOT in:

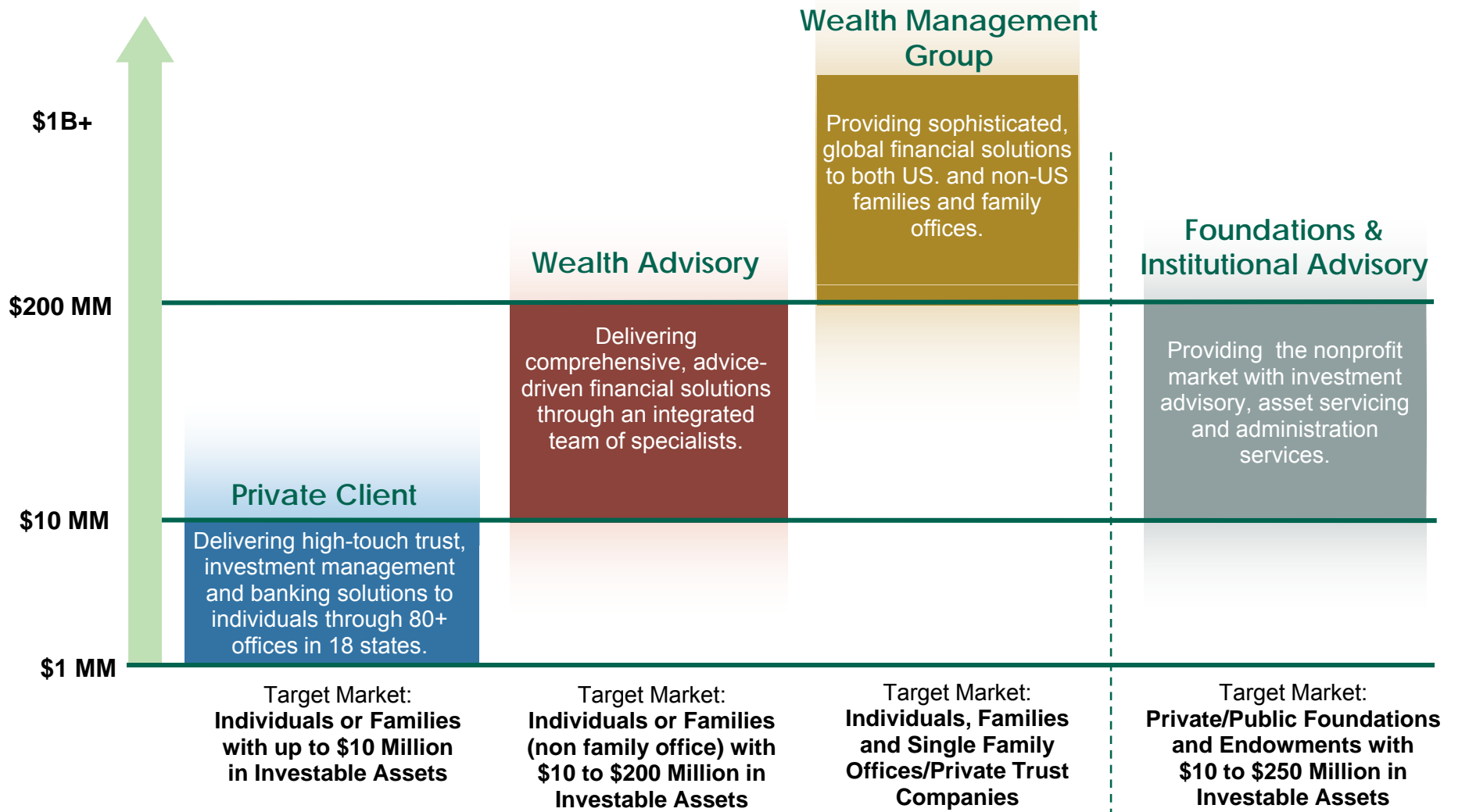
- Investment Banking
- Sub-Prime Mortgage Underwriting
- Asset Backed Commercial Paper Conduits
- Discount Brokerage
- American Depositary Receipts
- Merchant Card Processing
- Retail Banking
- Consumer Finance
- Venture Capital
- Stock Transfer



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# Uniquely Positioned to Serve the Affluent Marketplace



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# Demographic Trends

## TRENDS

Death & Taxes

## LEGAL ENVIRONMENT

2001 Tax Act (EGTRRA)  
2010 Tax Inaction

## IMPLICATIONS

Pre and Post-Mortem Estate  
Planning Strategies, De-Coupling,  
Formula Failures



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# Federal Estate Tax Exemptions and Rates

<b>Year</b>	<b>Estate Tax Exemption</b>	<b>Top Estate Tax Rate</b>
1997	\$600,000	55%
1998	\$625,000	55%
1999	\$650,000	55%
2000	\$675,000	55%
2001	\$675,000	55%
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Unlimited	0%
2011	\$1,000,000	55%



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# Federal Estate Return Filing Statistics

<b>Year of Death</b>	<b>Estate Tax Exemption</b>	<b>FETs Filed</b>	<b>FETs Paying Tax</b>	<b>Net FET Paid</b>
2001	\$675,000	109,562	50,456	\$23.7BB
2004	\$1,500,000	42,239	19,294	\$22.2BB
2007*	\$2,000,000	38,031	17,416	\$22.5BB
2009+	\$3,500,000	17,500	7,200	\$16.3BB

Data from Internal Revenue Service

\* 2007 data reflect all returns filed regardless of year of death

+ 2009 data are estimates



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# Demographic Trends

## TRENDS

Death & Taxes

**Changes in  
Capital Markets**

## LEGAL ENVIRONMENT

2001 Tax Act (EGTRRA)  
2010 Tax Inaction

**Prudent Investor Rule  
Uniform Prudent Management  
of Institutional Funds Act**

## IMPLICATIONS

Pre and Post-Mortem Estate  
Planning Strategies, De-Coupling,  
Formula Failures

**Evolution of Securities  
Markets and Asset  
Management Practices**

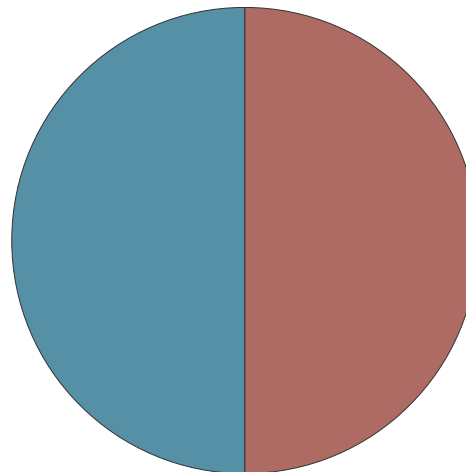


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# Traditional Trust Portfolio (Pre-Prudent Investor Rule)

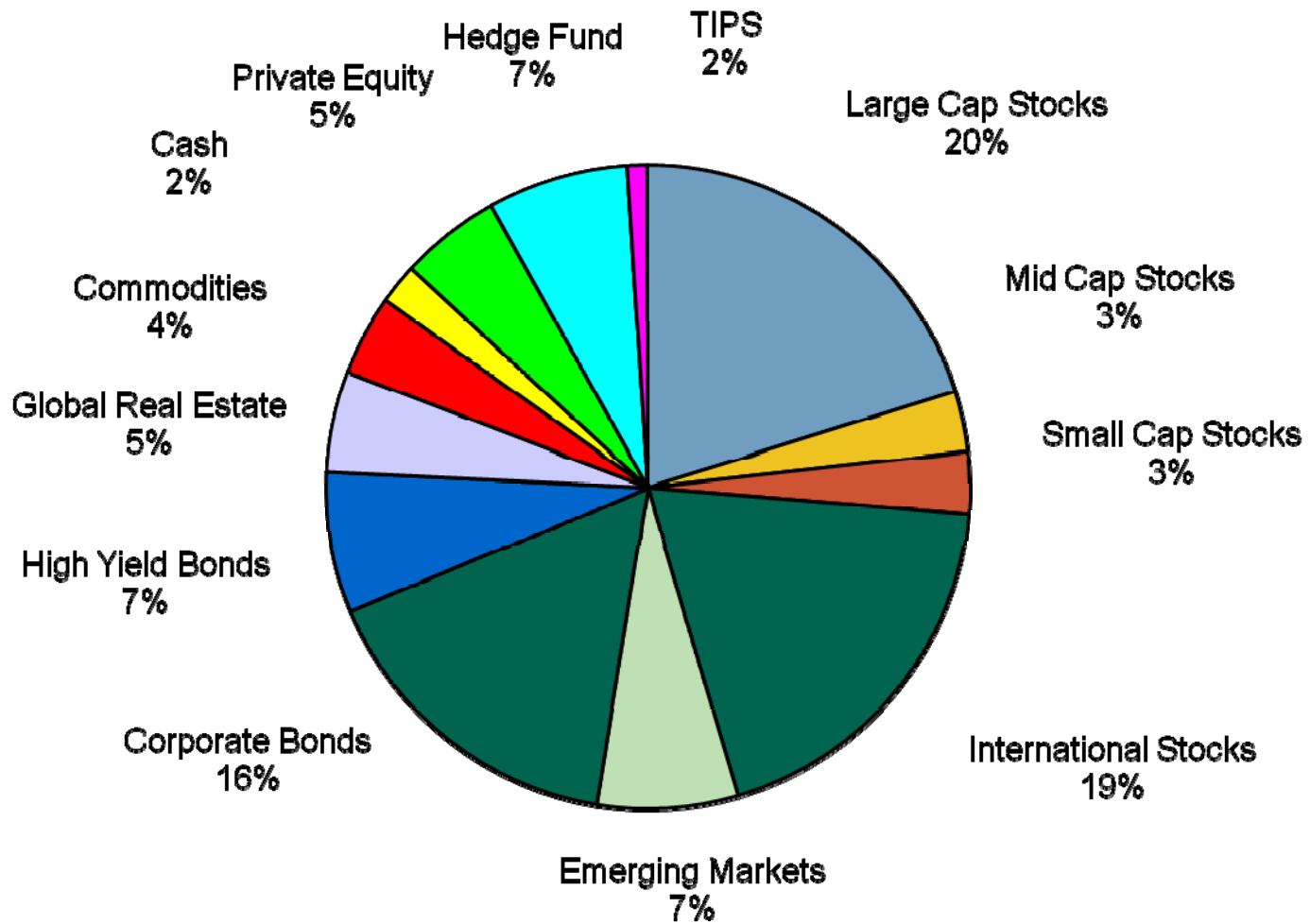
Large Cap  
Domestic Stocks  
50%



Domestic  
Bonds and Cash  
50%



# Diversified Trust Portfolio – Post-Prudent Investor Rule





# Myriad Issues for the “Prudent” Fiduciary Investor

1. Nature of Trust
  - ◆ Traditional net income / discretionary principle
  - ◆ Total return unitrust
  - ◆ Net income with principal adjustments
  - ◆ Impact of unitrusts / adjustments on allocation of tax attributes
2. Return expectations and risk tolerance
3. Time horizon
4. Asset allocation
5. Degree of diversification
  - ◆ Asset class
  - ◆ Sub-asset class
  - ◆ Style
  - ◆ Manager
6. Balance between active and passive investing
7. Balance between individually managed securities and commingled management
8. Proprietary v. delegated asset management
9. Ultimate costs of asset management / impact on return



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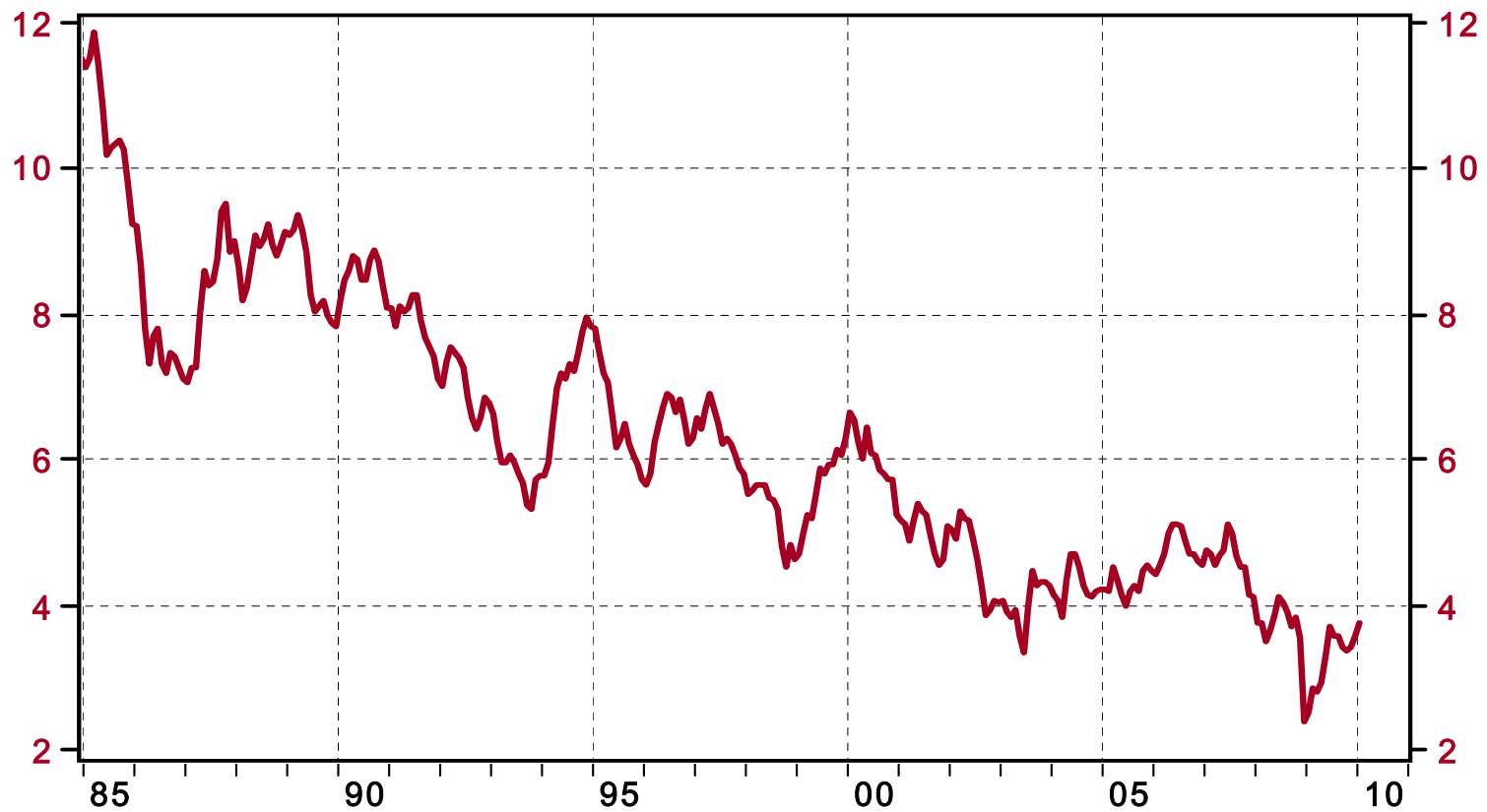
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<b>TRENDS</b>	<b>LEGAL ENVIRONMENT</b>	<b>IMPLICATIONS</b>
Death & Taxes	2001 Tax Act (EGTRRA) 2010 Tax Inaction	Pre and Post-Mortem Estate Planning Strategies, De-Coupling, Formula Failures
Changes in Capital Markets	Prudent Investor Rule Uniform Prudent Management of Institutional Funds Act	Evolution of Securities Markets and Asset Management Practices
<b>Decline in Yields</b>	<b>Unitrusts and Principal / Income Adjustments</b>	<b>Changes in Asset Allocation, Distribution Practices, and Taxation of Distributions</b>



## 10-Year Treasury Note Yield at Constant Maturity

% p.a.



Source: Federal Reserve Board /Haver Analytics

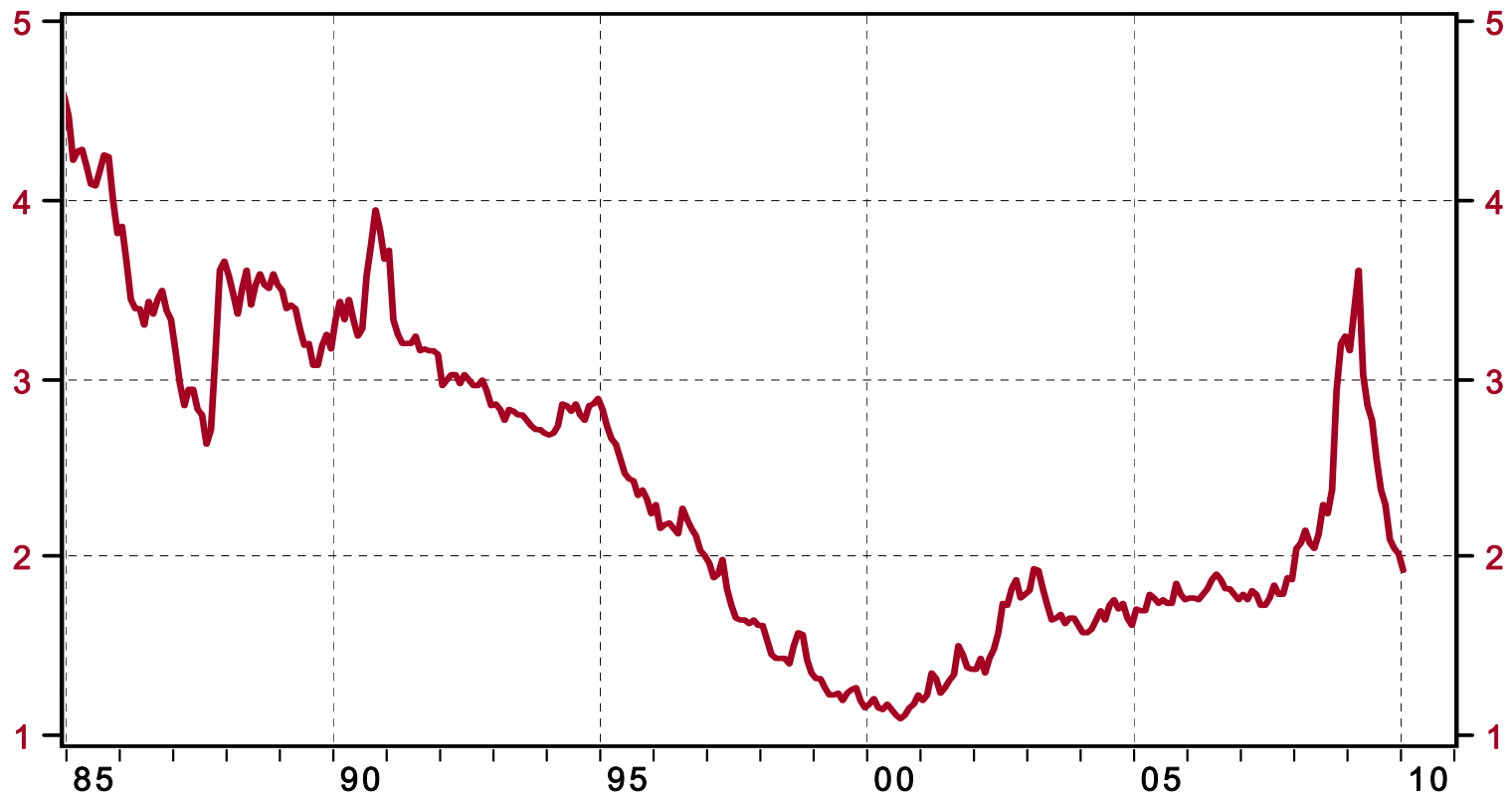


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## S&P: Composite 500, Dividend Yield

%



Source: Standard and Poor's/Haver Analytics



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## Demographic Trends

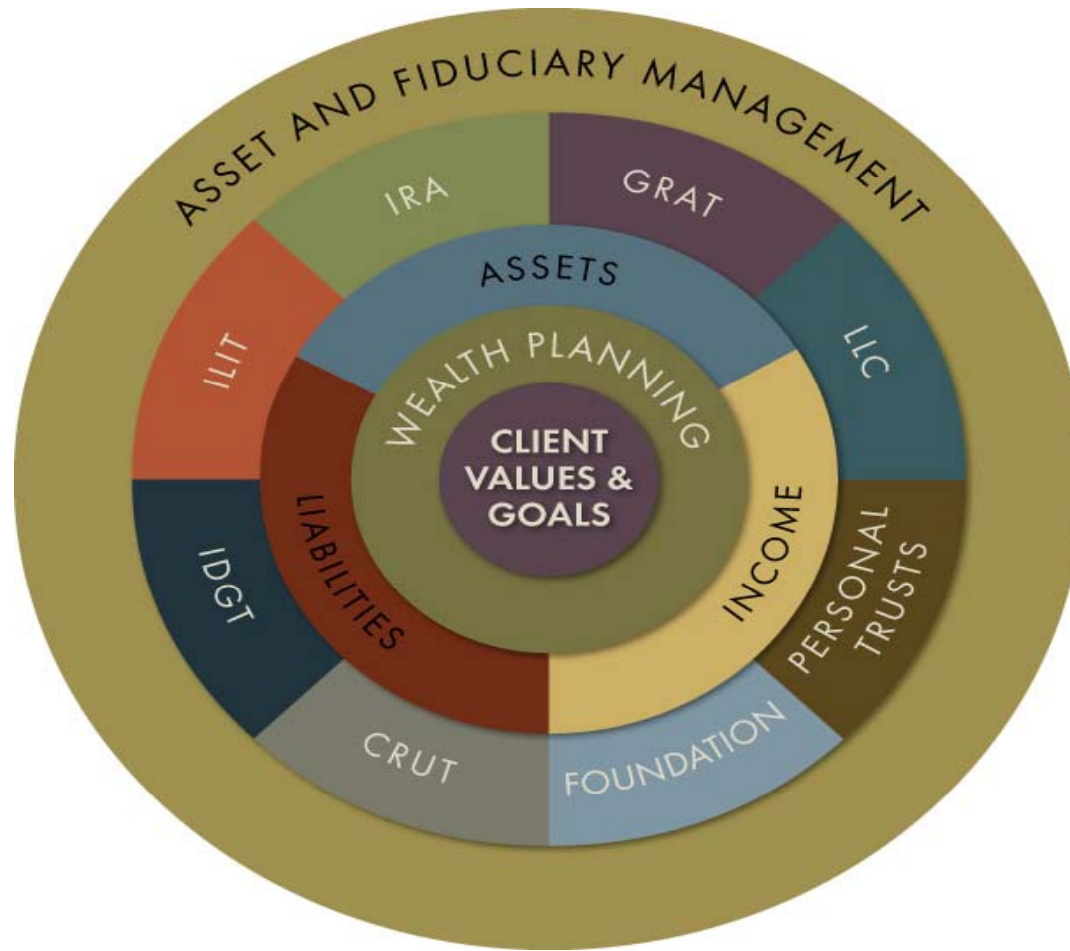
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<b>Wealth Diminution, Reconstitution</b>	<b>Fiscal and Tax Environment Regulatory Environment</b>	<b>Risk Aversion, Tax Navigation, Wealth Transfer Opportunities</b>



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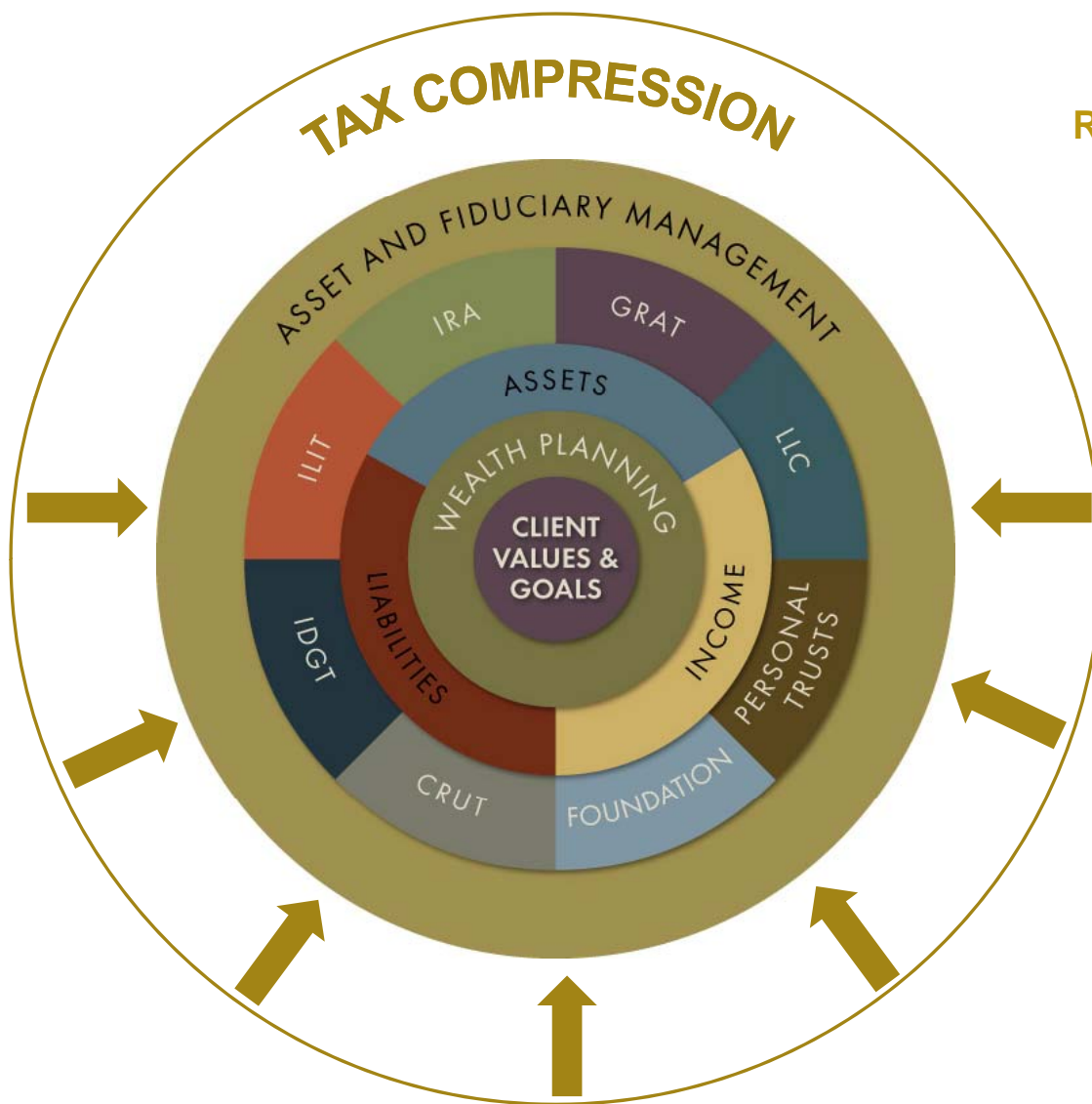


# Navigating a Changing Tax Landscape





# Navigating a Changing Tax Landscape

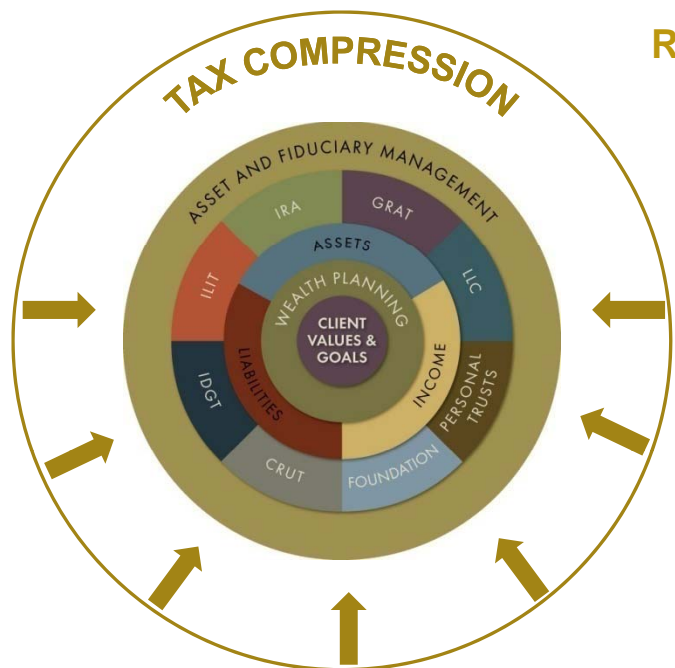


## Rising Taxes

- Federal Income Taxes
  - ◆ Ordinary income
  - ◆ Capital gains
  - ◆ Qualified dividends
- Federal Transfer Taxes
- State Taxes
  - ◆ Income
  - ◆ Transfer
  - ◆ Sales
- Regional and Local Taxes
  - ◆ Property
  - ◆ Sales
  - ◆ User fees
  - ◆ Transaction fees



# Navigating a Changing Tax Landscape



## Rising Taxes

- Federal Income Taxes
  - ◆ Ordinary income
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  - ◆ Transaction fees

## TAX STRATEGIES

- Planning
- Asset Location
- Asset Management
- Fiduciary Management
- Domicile



# Fiduciary Issues with Common Wealth Transfer Techniques

## I. Intentionally Defective Grantor Trusts

- ◆ Can trustee consider grantor's tax circumstances in making investment decisions?
- ◆ If trust assets were acquired with an installment note and have declined in value, should the note terms be renegotiated?
- ◆ Should the grantor retain powers indefinitely?
- ◆ When should the trustee advise the beneficiaries about looming issuance of K-1's?



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# Fiduciary Issues with Common Wealth Transfer Techniques

## II. Grantor Retained Annuity Trusts

- ◆ For GRATs with asset price volatility, should the portfolio be:
  - ▶ Actively managed, to reap gains
  - ▶ Passively managed, to let values take their course
- ◆ Should assets with severely depressed values be re-purchased and re-GRAT'ed?
- ◆ When Re-GRAT'ing
  - ▶ Should the power of substitution be used for an asset swap?
  - ▶ If assets are re-purchased, what consideration should be provided?
    - Cash
    - Installment note



# Demographic Trends

<b>TRENDS</b>	<b>LEGAL ENVIRONMENT</b>	<b>IMPLICATIONS</b>
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Wealth Diminution, Reconstitution	Fiscal and Tax Environment Regulatory Environment	Risk Aversion, Tax Navigation, Wealth Transfer Opportunities
<b>Client Mobility</b>	<b>Uniform Trust Laws Non-Uniform State Tax Laws</b>	<b>Tax Deterrents &amp; Incentives to Mobility, Changes in Estate Planning &amp; Trust Administration</b>



# Demographic Trends

TRENDS	LEGAL ENVIRONMENT	IMPLICATIONS
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Client Mobility	Uniform Trust Laws Non-Uniform State Tax Laws	Tax Deterrents & Incentives to Mobility, Changes in Estate Planning & Trust Administration
<b>New Generation of Clients</b>	<b>Trust Friendly Jurisdictions, Fiscal Implications of Aging Population</b>	<b>Legacy Planning, Family Governance, Planning and Administration for Non-Traditional Families, Modification of Trustee Duties, Situs Shopping</b>

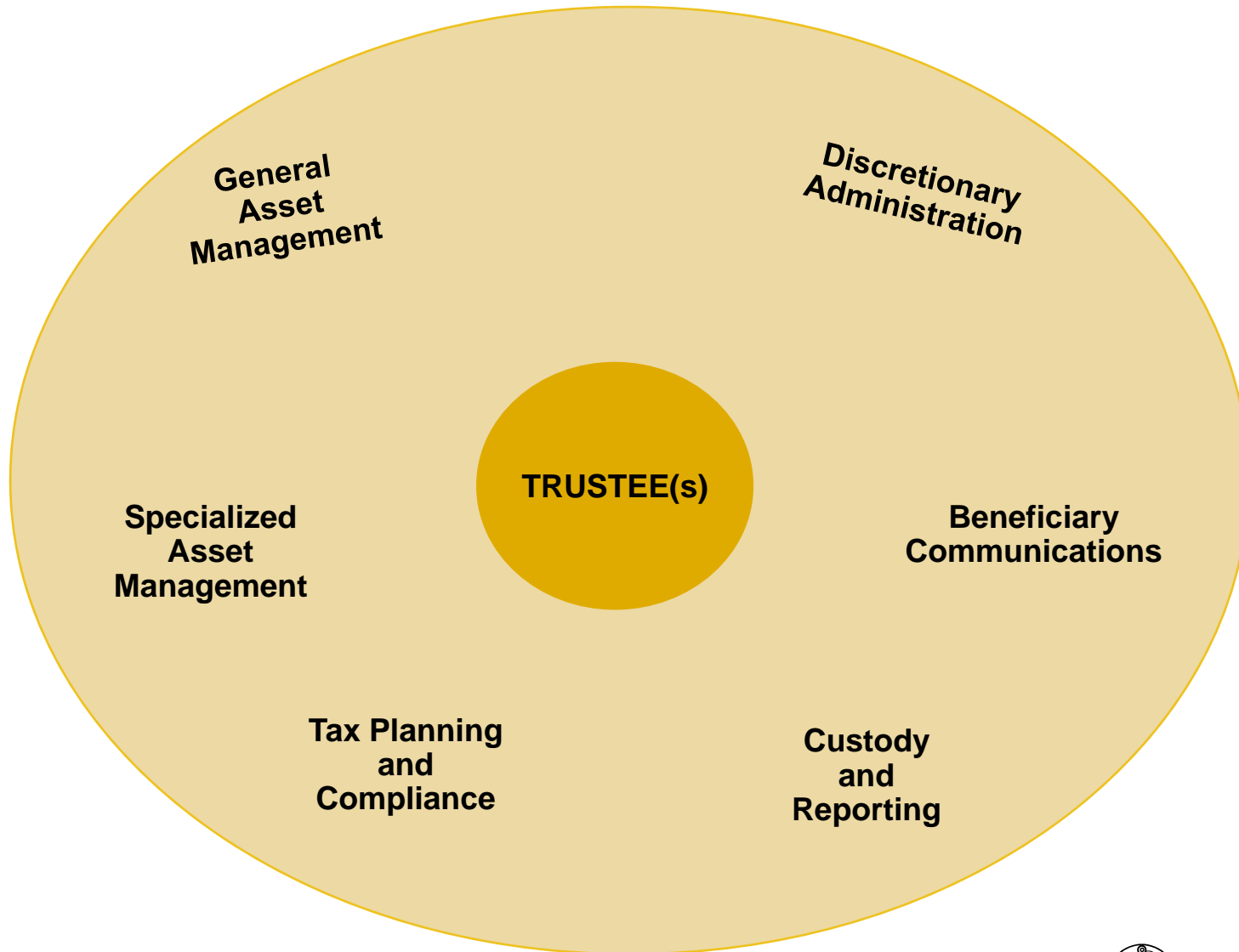


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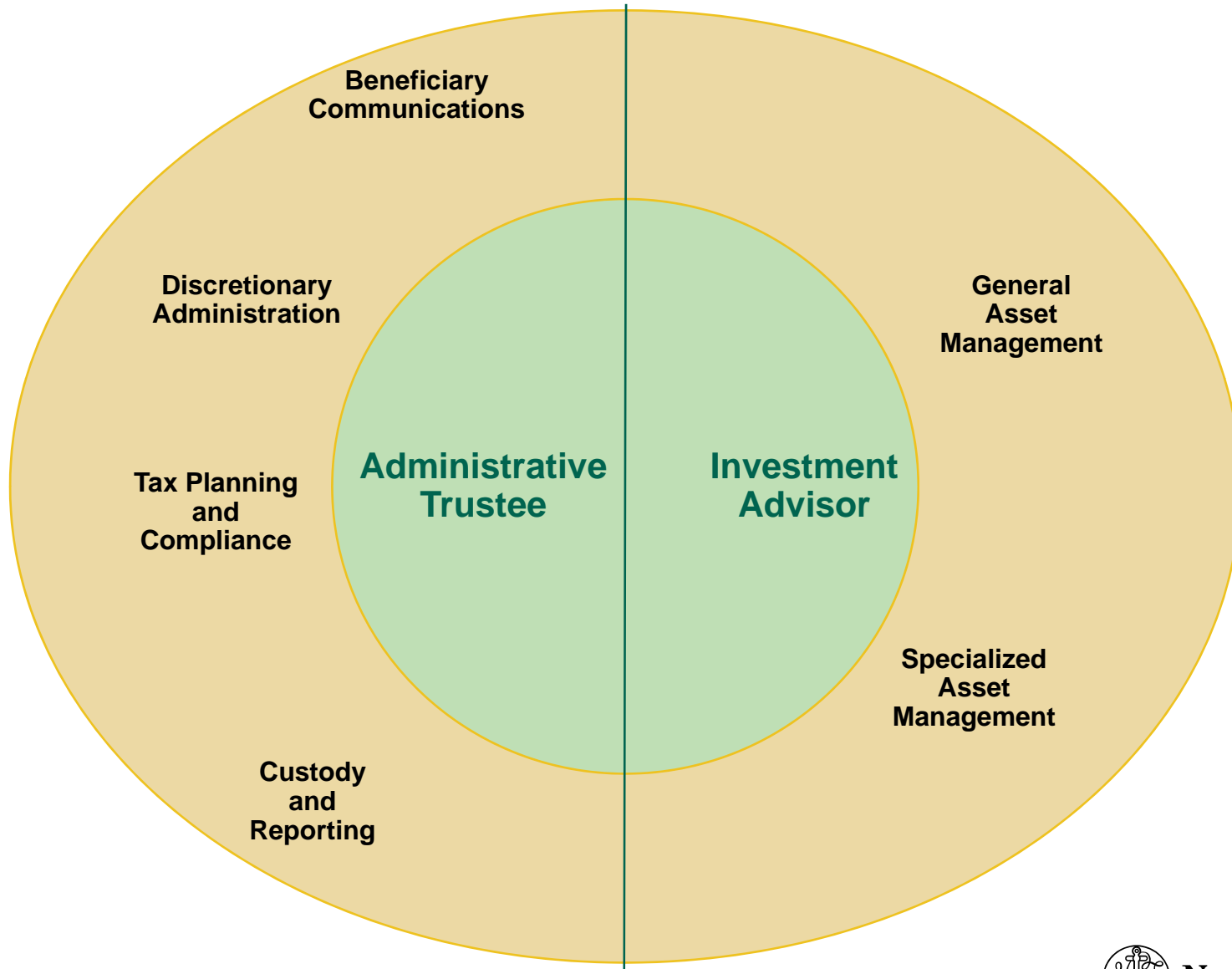


# Changes In Trust Design - Conventional Trust



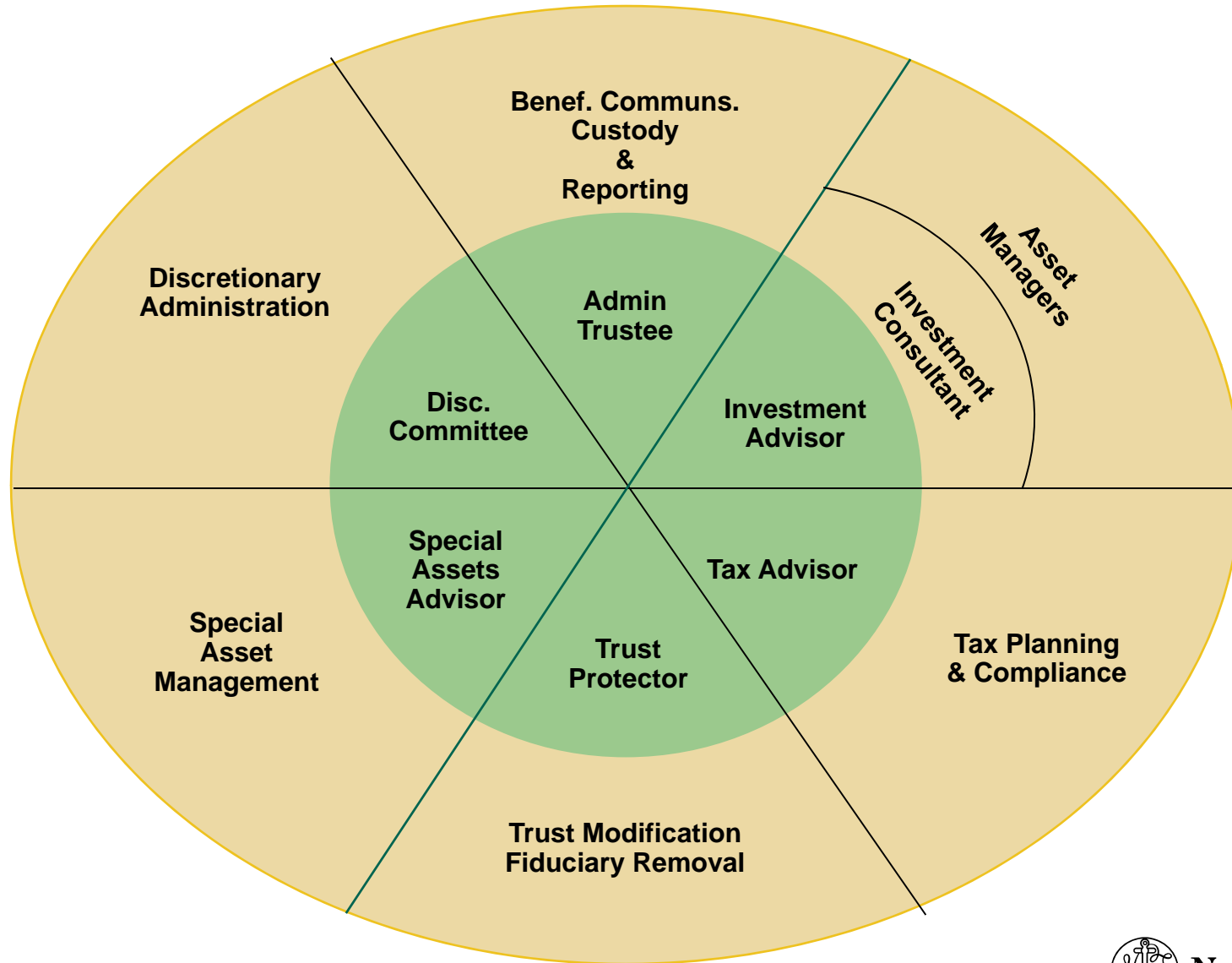


# Changes In Trust Design - Bifurcated Trust





# Changes In Trust Design – Enterprise Trust





# Practical Issues with Dispersion of Fiduciary Responsibility

## I. What standard of conduct applies to advisors?

- ◆ Few states provide a default
- ◆ For important advisory roles, the trust document should clarify that they are fiduciaries

## II. What degree of oversight should the primary trustee exercise over advisors' actions (or inactions)?

- ◆ Consider the grantor's intent and the feasibility of trustee oversight and draft accordingly
- ◆ Absent guidance in the trust document, only a few states provide standards for trustee intervention:
  - ▶ Delaware: Advisor's willful misconduct
  - ▶ Uniform Trust: Code §808(b) Advisor's actions are manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust.
  - ▶ Restatement (2d) §185 If under the terms of a trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power.



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## Asset Concentrations and the Duty of Diversification

- Maximizing Opportunities
- Minimizing Risks



## Statutory and Judicial Pronouncements on Diversification

### I. **Uniform Prudent Investor Act, Section 3. Diversification**

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

### II. **Restatement Third, Trusts §91F.**

Whether and to what extent a specific investment authorization may affect the normal duty to diversify the trust portfolio (see §90, Comment g) can be a difficult question of interpretation. **Because permissive provisions do not abrogate the trustee's duty to act prudently and because diversification is fundamental to prudent risk management, trust provisions are strictly construed against dispensing with that requirement altogether.**

Nevertheless, a relaxation in the degree of diversification may be justified under such an authorization by special opportunities for the trust or by special objectives of the settlor.

### III. **Wood v. U.S. Bank, N.A. 160 Ohio App 3d 831, 2005**

A trustee's duty to diversify may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust. But this statement is true only if the instrument creating the trust clearly indicates an intention to abrogate the common law, now statutory, duty to diversify.



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## Client Concerns About Diversification

- Adverse Income Tax Consequences
- Unfamiliarity with Other Asset Classes
- Loss of Control
- Performance Expectations
- Impact on Portfolio Yield
- Legacy Holdings
- Fees



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## Reasons for Non-Diversification

- Purpose of Trust
- Legacy Holdings
- Termination Date of Trust
  - ◆ Interests of Beneficiaries
  - ◆ Step-Up in Basis
- Illiquidity
- Loss of Controlling Interest
- Related Trusts' Holdings
- Beneficiaries' Assets
- Adverse Income Tax Consequences





## Retention Language

- Identify the Asset
- Explicitly Waive the Duty to Diversify
- Articulate the Reasons for Retention
- Address Asset “Conversion” Issues
  - ◆ Equities: Mergers, Acquisitions, Spin-offs
  - ◆ Real Estate: Sale, Reinvestment
- Identify the Circumstances Under Which, and by Whom, Sale Should be Considered
- Consider Modifying the Fiduciary’s Standard of Care
- If the Asset has Unfunded Operating or Holding Costs, Endow Them
- If the Asset’s Retention May Cause Contention Among Beneficiaries:
  - ◆ Protect the Fiduciary
  - ◆ Provide a Mechanism for Dispute Resolution





# Concentration Risk Management Process

- Definition and Identification
- Review Process
- Evaluation of Fiduciary Responsibility
- Evaluation of Strategies
- Implementation and Periodic Review
- Documentation
- Summary:  
Policy → Process → Analysis → Application → Memorialization







Pre And Post-Mortem Estate Planning

After The Repeal of the State Death Tax Credit





## State Estate / Inheritance Tax Landscape – 2010

State	Type	Exemption
Alabama	None	
Alaska	None	
Arizona	None	
Arkansas	None	
California	None	
Colorado	None	
Connecticut	Estate	\$2,000,000 (2009) \$3,500,000 (2010)
Delaware	Pre-2001 Pickup	\$3,500,000
D. of Columbia	Pre-2001 Pickup	\$1,000,000
Florida	None	
Georgia	None	
Hawaii	None	
Idaho	None	
Illinois	Pre-2001 Pickup	\$2,000,000
Indiana	Inheritance	
Iowa	Inheritance	
Kansas	Estate & Inheritance	\$1,000,000
Kentucky	Inheritance	
Louisiana	None	



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## State Estate / Inheritance Tax Landscape – 2010

<b>State</b>	<b>Type</b>	<b>Exemption</b>
Maine	Pre-2001 Pickup	\$1,000,000
Maryland	Pre-2001 Pickup & Inheritance	\$1,000,000
Massachusetts	Pickup	\$1,000,000
Michigan	None	
Minnesota	Pre-2001 Pickup	\$1,000,000
Mississippi	None	
Missouri	None	
Montana	None	
Nebraska	Inheritance	
Nevada	None	
New Hampshire	None	
New Jersey	Pre-2001 Pickup & Inheritance	\$ 675,000
New Mexico	None	
New York	Pre-2001 Pickup	\$1,000,000
North Carolina	None	
North Dakota	None	
Ohio	Estate	\$ 338,333
Oklahoma	None	
Oregon	Pre-2001 Pickup	\$1,000,000



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## State Estate / Inheritance Tax Landscape – 2010

<b>State</b>	<b>Type</b>	<b>Exemption</b>
Pennsylvania	Inheritance	
Rhode Island	Pre-2001 Pickup	\$ 850,000
South Carolina	None	
South Dakota	None	
Tennessee	Inheritance	
Texas	None	
Utah	None	
Vermont	Pre-2001 Pickup	\$2,000,000
Virginia	None	
Washington	Estate	\$2,000,000
West Virginia	None	
Wisconsin	None	
Wyoming	None	



## Post-Mortem Perils in the Age of Decoupling

### I. EGTRRAs Replacement of the §2011 State Death Tax Credit with the §2058 State Death Tax Deduction precipitated:

- ◆ No federal revenue losses
- ◆ Substantial revenue losses in coupled states
- ◆ Myriad State death tax responses
  - ▶ Maintenance of pre-EGTRRA pick-up tax (i.e., no tax after 2004)
  - ▶ Decoupled tax tied to pre-EGTRRA §2011
  - ▶ Rejuvenated inheritance taxes
  - ▶ Stand-alone state death taxes
- ◆ Several unconstitutional state death tax statutes when applied to non-domiciliary tangible assets (*Cory v. White* 457 U.S. 85 1982)
- ◆ Re-emergence of domicile as an important variable in transfer tax costs
- ◆ Unnecessary complexity in pre and post-mortem planning



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# Estate Planning Compromises to the Decoupling Dilemma

## I. For States with no Transfer Tax or Full (Federal Level) Exclusion

- ◆ Bypass trust may be funded to full exclusion amount
- ◆ Pre EGTRRA minimum marital/maximum credit shelter formulas will generally fund the bypass trust to the full exemption amount

## II. For States with Transfer Tax and Lower Exclusion

- ◆ Preserve funding flexibility with a “least tax” formula and determine proper funding based on post-mortem circumstances
- ◆ Post-mortem funding techniques
  - ▶ Spousal disclaimer of marital trust
  - ▶ Partial QTIP election over marital trust
  - ▶ Clayton QTIP election by executor (Clayton v. Commissioner 976 F.2d 1486 5<sup>th</sup> Circuit 1992 and Treas. Reg. §20.2056(b)-7(d)(3))
  - ▶ State-only QTIP election over federal/state exemption excess



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# Estate Planning Compromises to the Decoupling Dilemma

## III. Factors to Evaluate in Post-Mortem Funding

- ◆ Anticipated size of surviving spouse's estate
- ◆ Surviving spouse's life expectancy
- ◆ Surviving spouse's needs for income and principal
- ◆ Possible federal and state transfer tax rates and exemptions at surviving spouse's anticipated date of death

## IV. Solving the Non-Domiciliary Property Puzzle

- ◆ Know both states' transfer tax systems and how they treat non-domiciliary property (and related liabilities)
- ◆ Use title to control treatment of the property as tangible (likely subject to local state's tax) or intangible (likely subject to domiciliary state's tax)



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## V. Sample of Marital Trust Form

FOURTH: As of my death the balance of the trust estate shall be held and disposed of as follows:

(a) If the federal estate tax is in existence at my death, the trustee shall hold and administer the trust estate as provided in the following articles of this agreement.

(b) If the federal estate tax is not in existence at my death, the trustee shall allocate the trust estate as follows:

\_\_\_% to the Marital Trust, if my wife survives me, and

\_\_\_% (or all thereof, if my wife does not survive me) to the Bypass Trust hereinafter established.

Northern Trust Will and Trust Forms are available online at: <http://wealthadvisor.northerntrust.com>

Go to the “Access Knowledge” column and then click on the “Will & Trust Forms” link.

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# Northern Trust Will and Trust Forms\*

## VI. Sample of Marital Trust Form

FIFTH: If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust for her benefit (undiminished to the extent possible by any estate or inheritance taxes or other charges) a fraction of the trust property of which

(a) the numerator is the smallest amount which, if allowed as a federal estate tax marital deduction, would result in the least possible aggregate of (i) federal estate tax and (ii) state death taxes which are based upon the state death tax credit, that would be payable by reason of my death, and

(b) the denominator is the federal estate tax value of the assets included in my gross estate which became (or the proceeds, investments or reinvestments of which became) trust property.

In determining the amount of the numerator the trustee shall assume that none of the Bypass Trust qualifies for a federal estate tax deduction.

For purposes of the preceding paragraph, the trust property is all property in the trust estate, including any property added thereto by my will, which was not paid pursuant to the preceding articles of this agreement and which would qualify for the federal estate tax marital deduction if it were distributed outright to my wife. For purposes of this agreement, my wife shall be deemed to have survived me if the order of our deaths cannot be proved.

Any part of the trust disclaimed by my wife shall be added to or used to fund the Bypass Trust. The disclaimer shall not preclude my wife from receiving benefits from the disclaimed property in the Bypass Trust, but my wife shall not have any power to appoint the portion of the Bypass Trust attributable to the disclaimed property.

My wife shall have the right by written notice to require the trustee to convert unproductive property in the trust to productive property within a reasonable time.

The trust shall be designated the "Marital Trust" and shall be held and disposed of as follows:

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Unitrust Conversions and the Power to Adjust

When Should a Fraction Trump a Yield?





## Unitrust & Adjustment Statutes – 2010

<b>State</b>	<b>Power to Adjust</b>	<b>Unitrust Conversion</b>
Alabama	Yes	No
Alaska	Yes	Yes
Arizona	Yes	Yes
Arkansas	Yes	No
California	Yes	Yes
Colorado	Yes	Yes
Connecticut	Yes	No
Delaware	Yes	Yes
District of Columbia	Yes	No
Florida	Yes	Yes
Georgia	Yes	Yes
Hawaii	Yes	No
Idaho	Yes	No
Illinois	No	Yes
Indiana	Yes	Yes
Iowa	No	Yes



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## Unitrust & Adjustment Statutes – 2010

<b>State</b>	<b>Power to Adjust</b>	<b>Unitrust Conversion</b>
Kansas	Yes	No
Kentucky	Yes	S/H
Louisiana	Yes	S/H
Maine	Yes	Yes
Maryland	Yes	Yes
Massachusetts	Yes	No
Michigan	Yes	No
Minnesota	Yes	No
Mississippi	No	No
Missouri	Yes	Yes
Montana	Yes	No
Nebraska	Yes	Yes
Nevada	Yes	No
New Hampshire	Yes	Yes
New Jersey	Yes	S/H
New Mexico	Yes	Yes
New York	Yes	Yes



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# Unitrust & Adjustment Statutes – 2010

State	Power to Adjust	Unitrust Conversion
North Carolina	Yes	Yes
North Dakota	No	No
Ohio	Yes	S/H
Oklahoma	Yes	No
Oregon	Yes	Yes
Pennsylvania	Yes	Yes
Rhode Island	Yes	Yes
South Carolina	Yes	No
South Dakota	No	Yes
Tennessee	Yes	No
Texas	Yes	Yes
Utah	Yes	No
Vermont	No	No
Virginia	Yes	Yes
Washington	Yes	Yes
West Virginia	Yes	Yes
Wisconsin	Yes	Yes
Wyoming	Yes	Yes

S/H: These states enacted a §104 power to adjust with a safe harbor for unitrusts



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## Reviewing Trusts for Potential Conversion

- Income only (mandatory or discretionary)
- Income with narrow power to discrete principal
- Income with moderate power to discrete principal
- Income with broad power to discrete principal



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## Unitrust Conversions and the Power to Adjust – Issues to be Analyzed

- Governing law
- Nature, purpose, duration of trust
- Settlor's intent
- Duty of impartiality vs. permissible partiality
- Beneficiary expectations
- Discretionary authority over principal distributions



## Unitrust Conversions and the Power to Adjust – Portfolio Issues

- Asset composition
- Asset allocation
- Portfolio size
- Reinvestment alternatives
- Re-allocation impact
- Investment management limitations
- Fixed income: taxable vs. tax-exempt



## Conversion Analysis – Critical Assumptions

- Time horizon
- Inflation rate
- Capital market assumptions
- Tax impact of portfolio re-allocation
- Rebalancing frequency
- Management costs
- Payout ratio
- Liquidity needs
- Return methodology

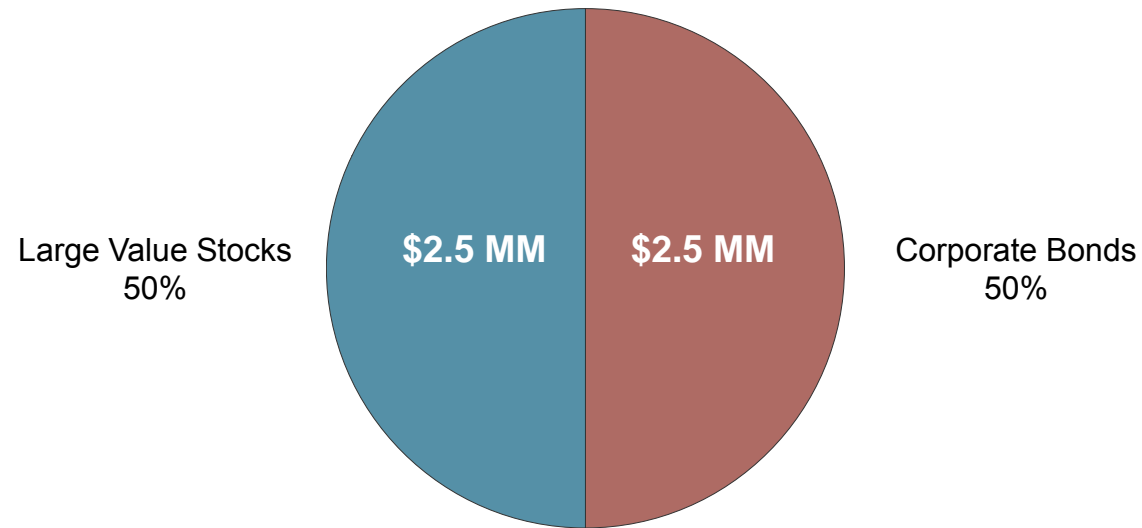


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# 50 / 50 Asset Allocation

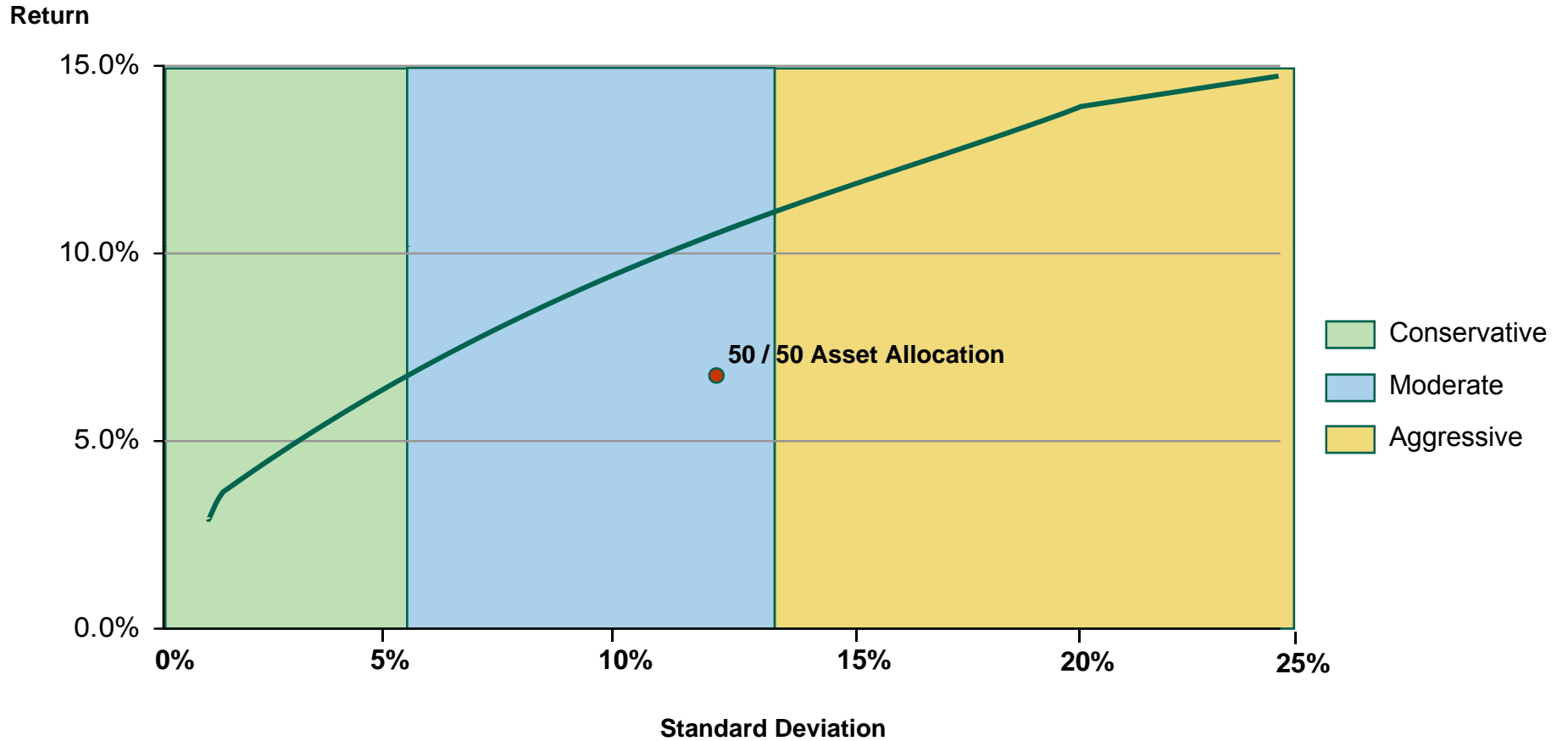
## *\$5 Million Portfolio*





# Diversified Portfolio Efficient Frontier

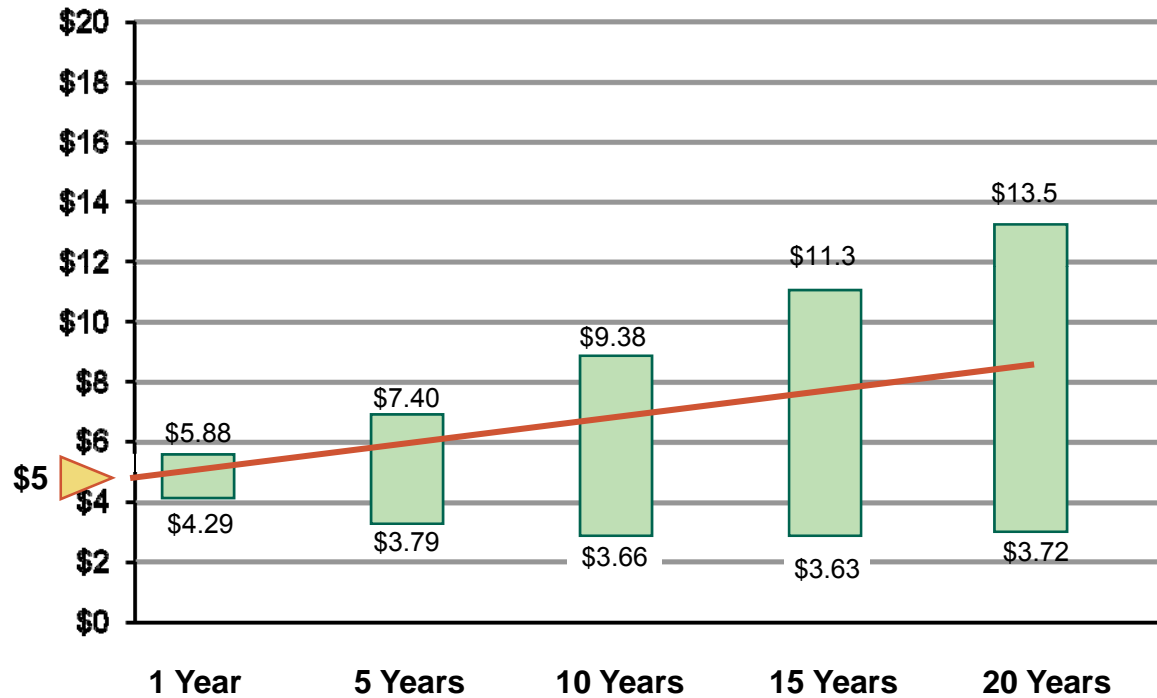
## \$5 Million Portfolio





## \$5 Million Portfolio

Asset Range (\$MM)



Payout 3%	1 Year	5 Years	10 Years	15 Years	20 Years
	\$150,000	\$159,721	\$174,645	\$190,571	\$208,695

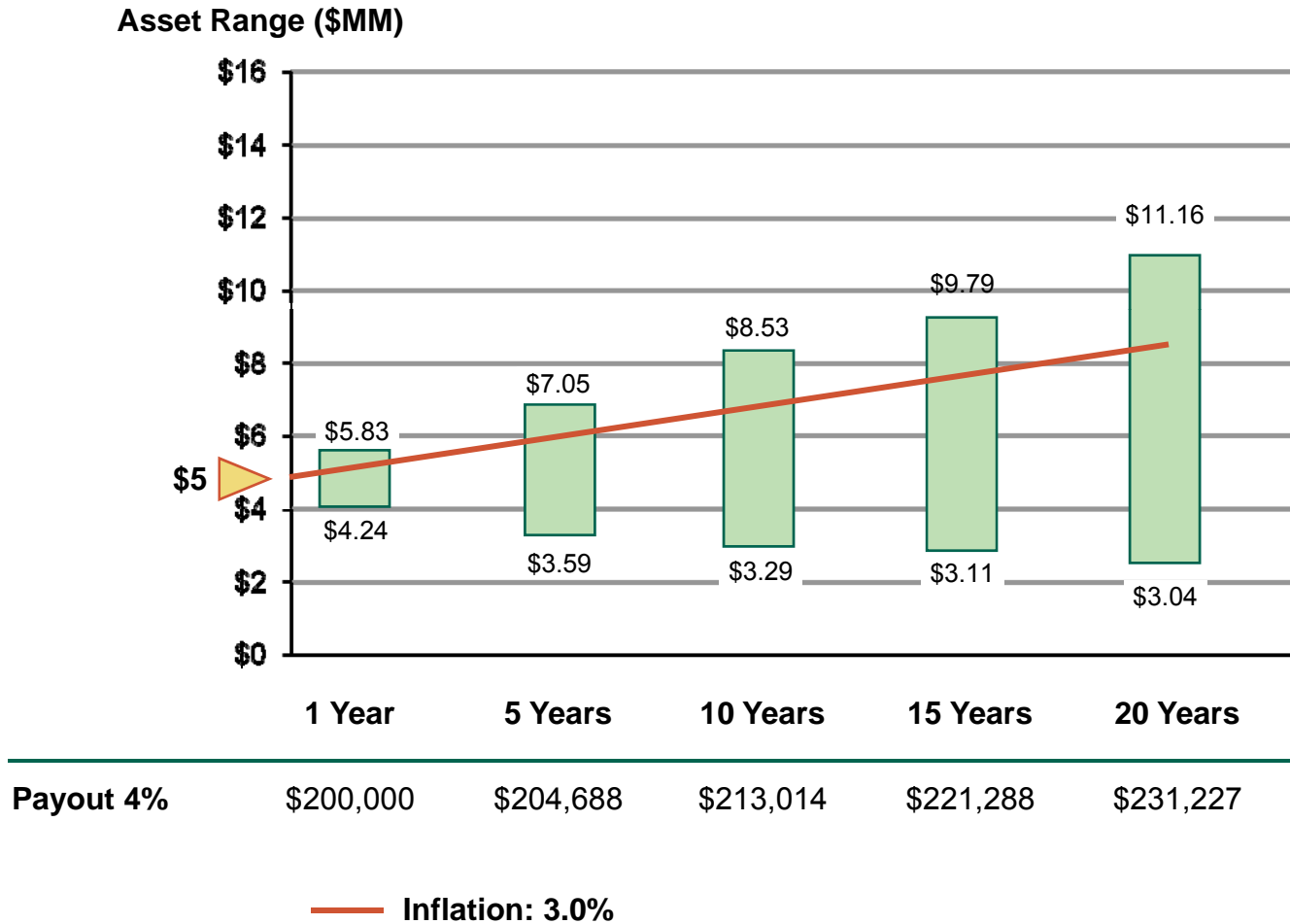
— Inflation: 3.0%





# Monte Carlo Simulation Analysis – 4% Payout

## \$5 Million Portfolio

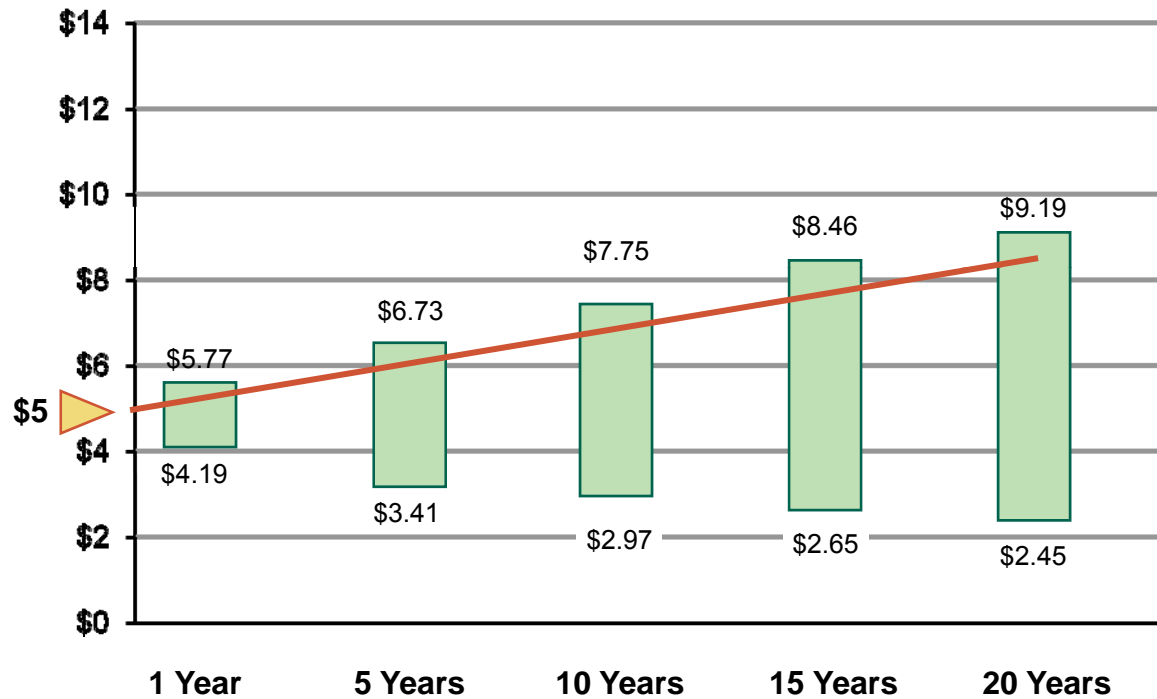




# Monte Carlo Simulation Analysis – 5% Payout

## \$5 Million Portfolio

Asset Range (\$MM)



Payout 5%	1 Year	5 Years	10 Years	15 Years	20 Years
	\$250,000	\$245,820	\$243,230	\$240,539	\$239,253

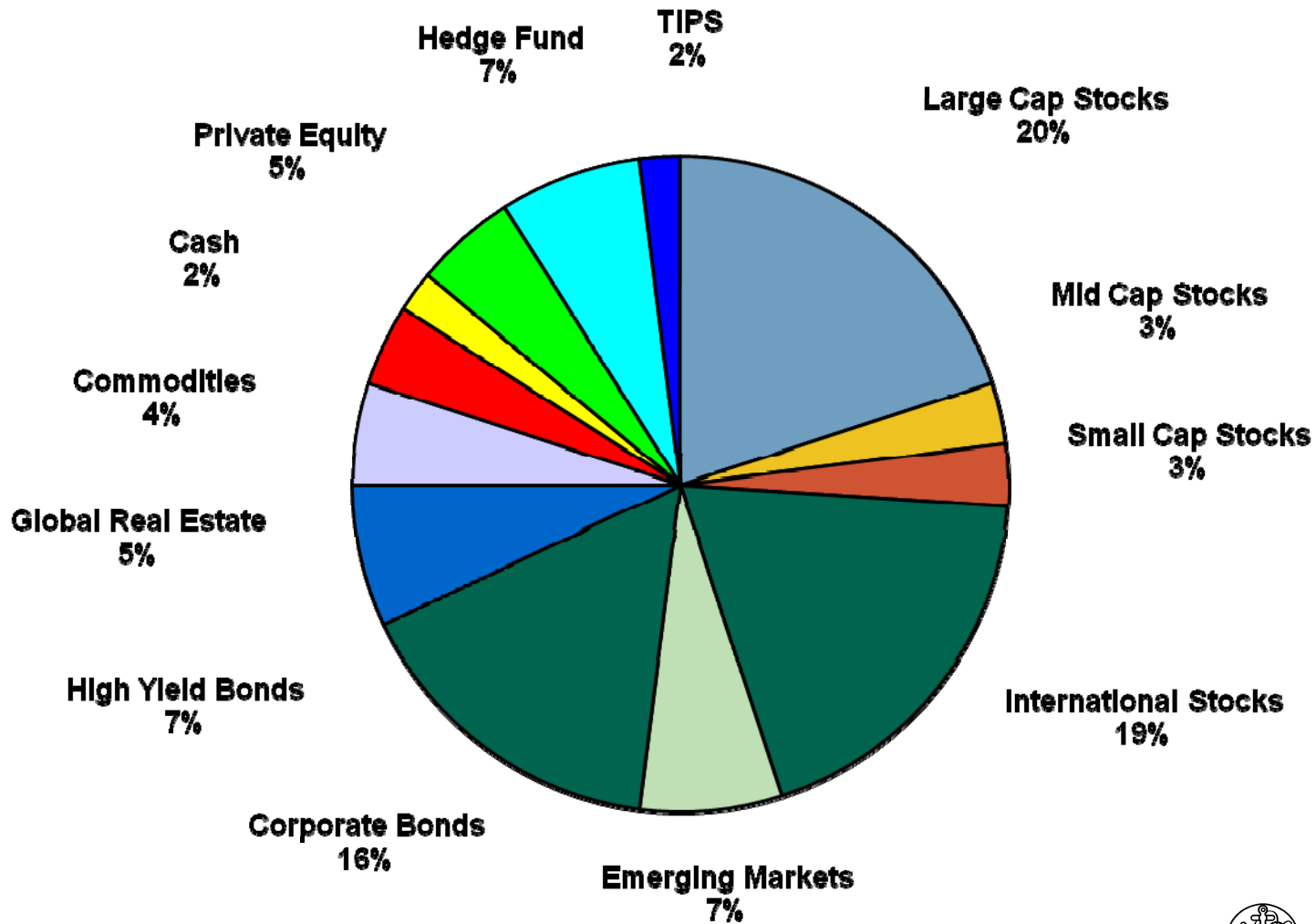
— Inflation: 3.0%





# Diversified Portfolio

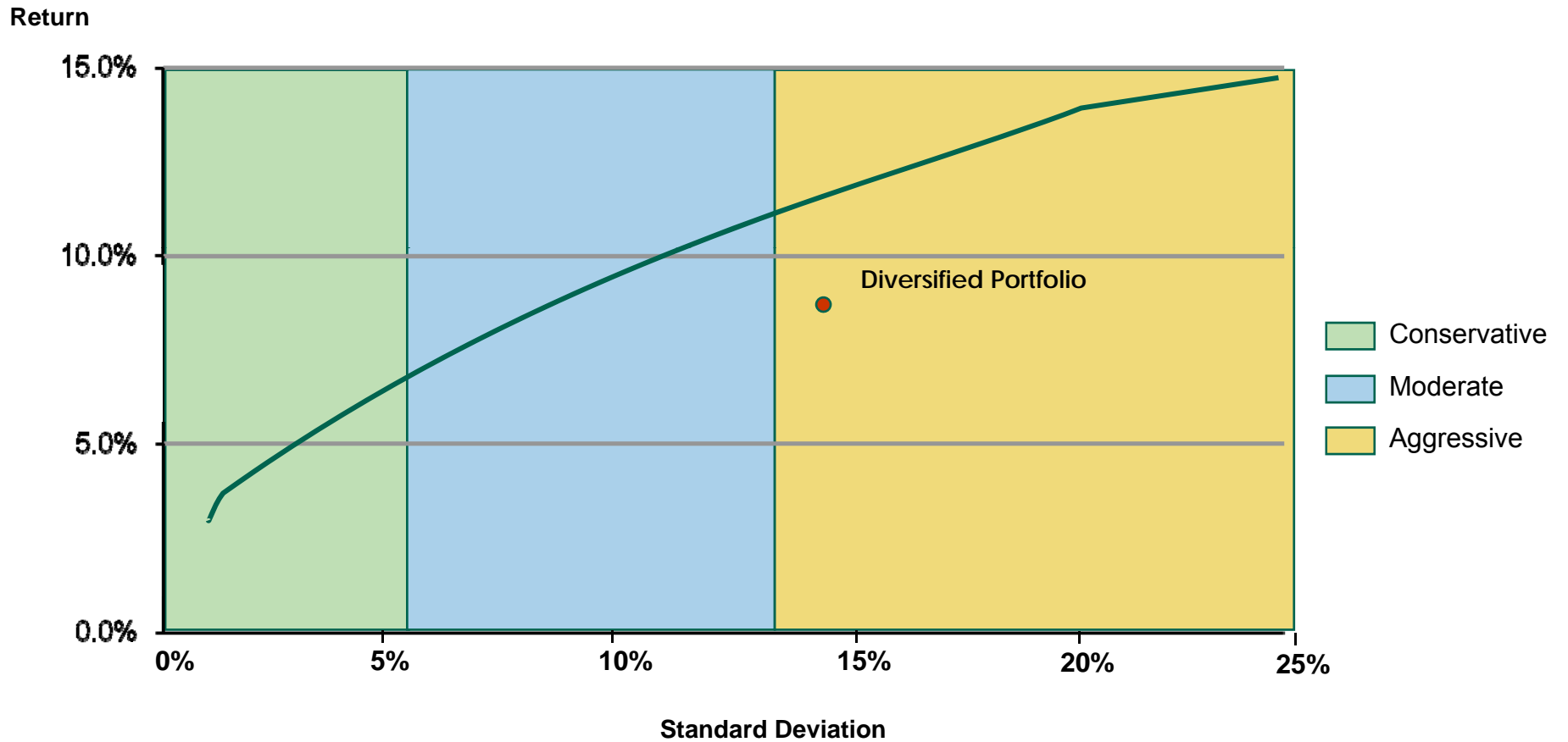
*\$4,714,249 Portfolio*





# Diversified Portfolio Efficient Frontier

*\$4,714,249 Portfolio*

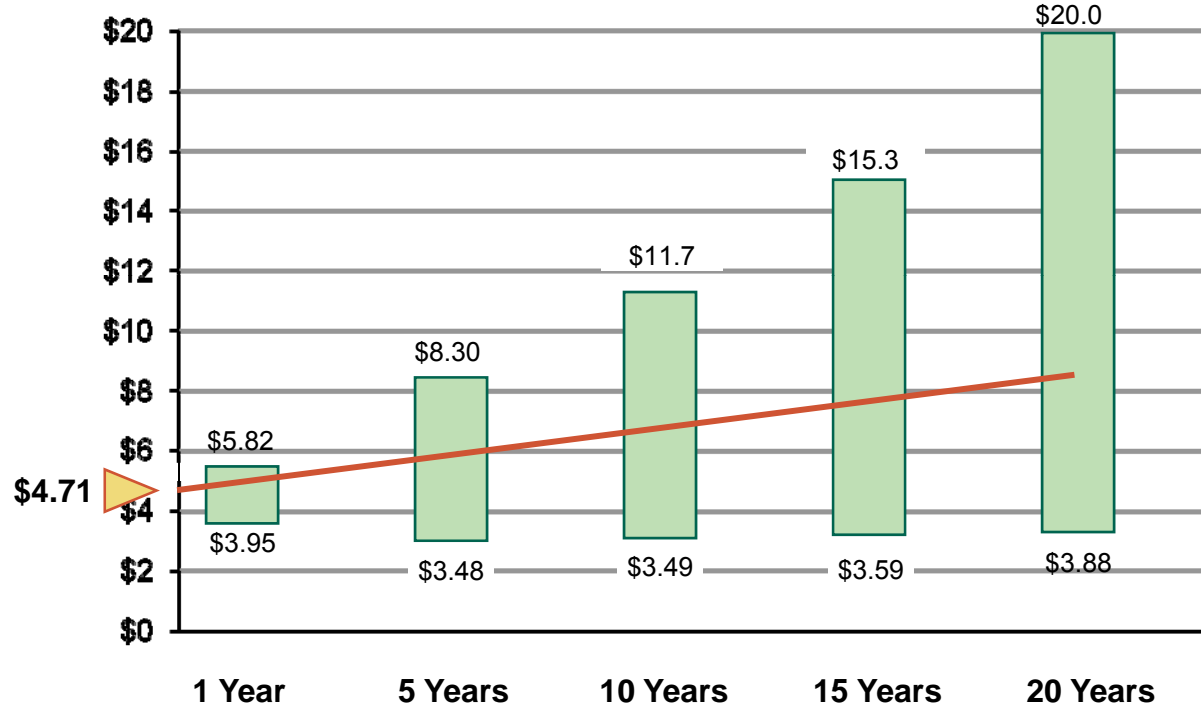




# Monte Carlo Simulation Analysis – 3% Payout

*\$4,714,249 Portfolio*

Asset Range (\$MM)



Payout 3%	1 Year	5 Years	10 Years	15 Years	20 Years
	\$141,427	\$159,413	\$186,592	\$216,961	\$257,923

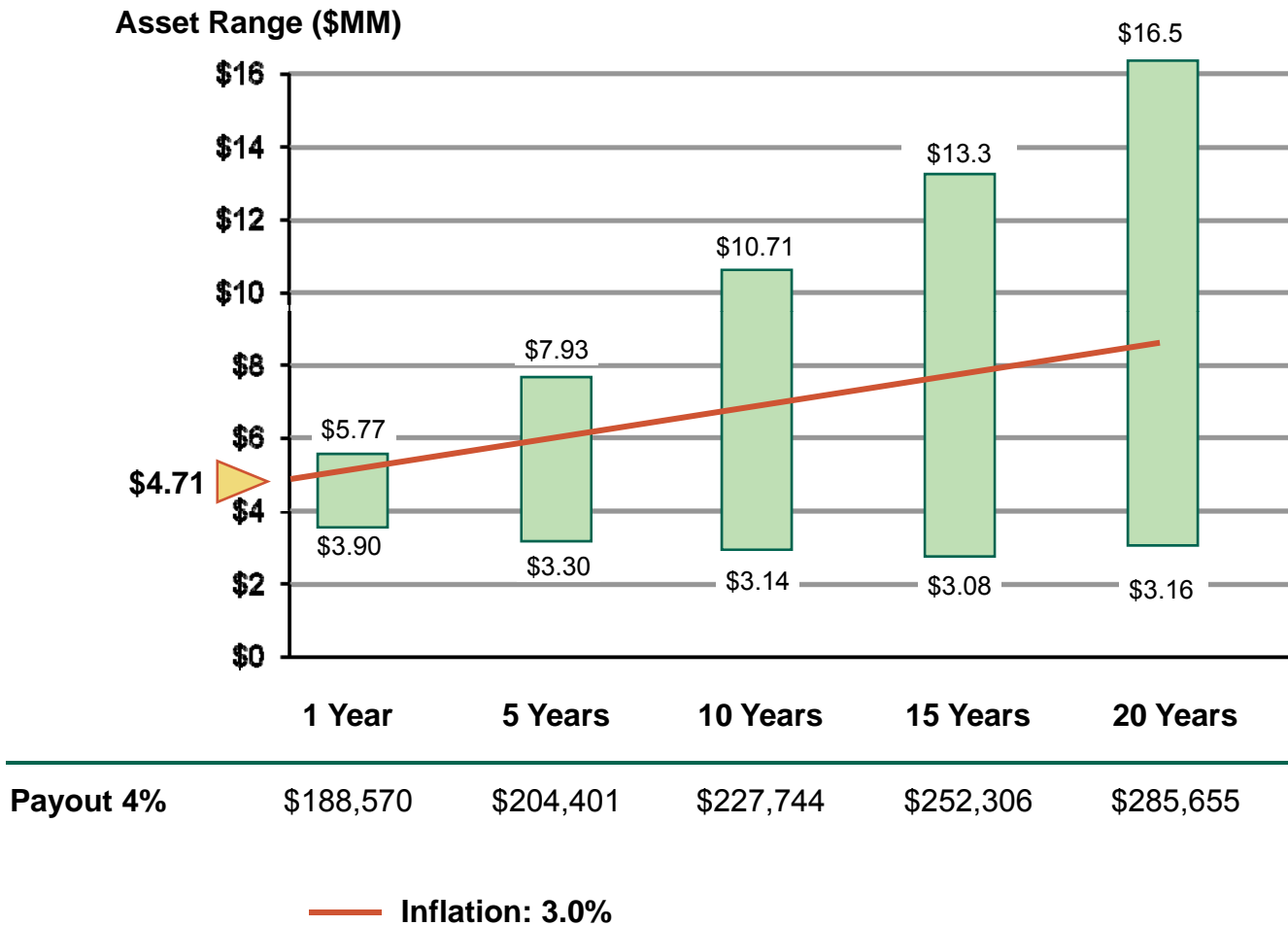
— Inflation: 3.0%





# Monte Carlo Simulation Analysis – 4% Payout

*\$4,714,249 Portfolio*

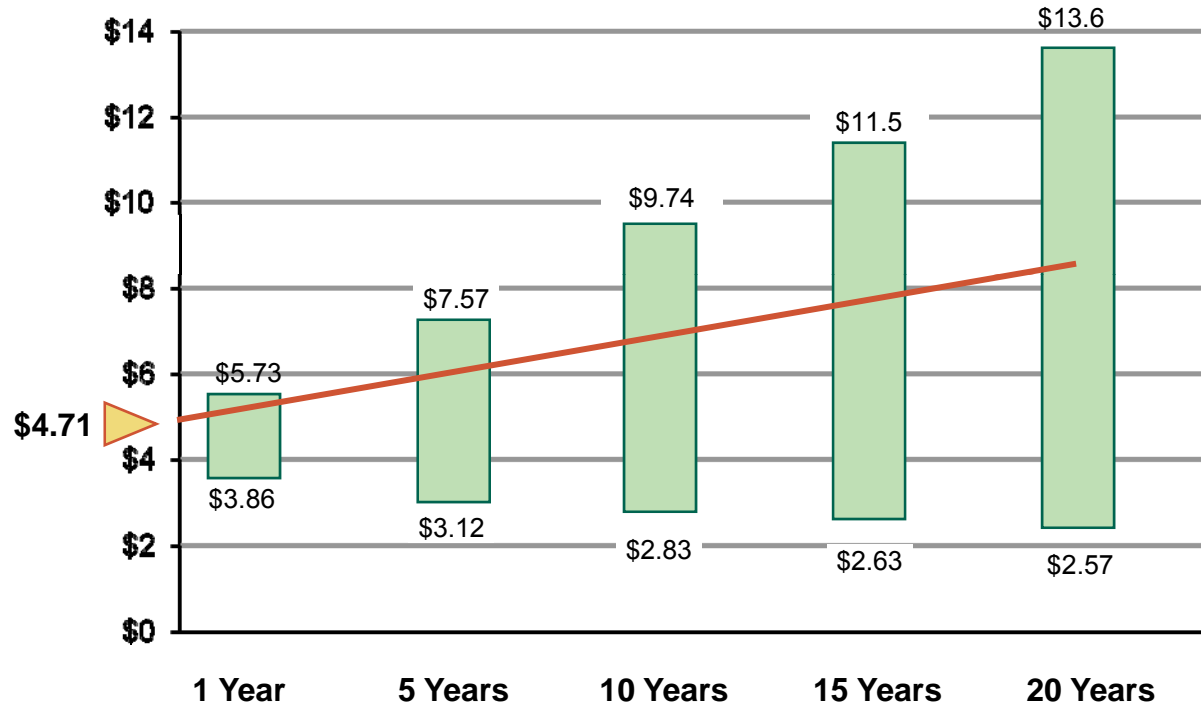




# Monte Carlo Simulation Analysis – 5% Payout

*\$4,714,249 Portfolio*

Asset Range (\$MM)



Payout 5%	1 Year	5 Years	10 Years	15 Years	20 Years
	\$235,712	\$245,623	\$260,394	\$274,668	\$296,013

— Inflation: 3.0%





# Disclosures

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