



Think Forward Act Now

Wealth Management for the New World

This **comprehensive approach to managing wealth** combines the innovative with the time-tested to help build more resilient, effective portfolios.

The world is changing. The entire economic and investment playing field is being restructured. Global growth is shifting from the developed to the developing world. Policy Band-Aids are being replaced with surgery, private sector funding is becoming public sector funding, deregulation is moving toward hyperregulation, and measures to spark recovery are growing bolder. Not surprisingly, all these trends affect investors in a big way.

Now is a critical time to revisit overall investment approaches and wealth management plans.

“At U.S. Trust, we continue to believe in the overriding importance of asset allocation and portfolio diversification,” says Joe Curtin, managing director of portfolio analytics and consulting for U.S. Trust. “But at the same time, we’re emphasizing a more active and tactical management style to take advantage of near-term movements in the market.

We’re also adopting a more comprehensive approach to managing risk and planning for liquidity needs.”

And asset “location” considerations provide an important overlay, adds Mitch Drossman, national director of planning strategies for U.S. Trust. “Where you hold your investments — whether in taxable or nontaxable accounts, or in various types of trusts — can have a real impact on after-tax investment returns. So during the planning process we consider asset allocation and asset location together, to leverage the characteristics of the assets and the accounts that hold them.”

“This comprehensive approach to wealth management can go a long way toward both dampening portfolio volatility and maximizing risk-adjusted, after-

tax investment returns,” says Curtin. “At U.S. Trust, this is something we take very seriously.”

“We think our approach is the most effective way of managing the connection between investment risk and aspirational, or lifestyle enhancement/protection, risk. It also helps us to better incorporate tax efficiency, investor psychology, wealth objectives and tactical market opportunities within each client portfolio on a customized basis,” adds Chris Hyzy, U.S. Trust’s chief investment officer.

DIVERSIFICATION WORKS

“When we examine the short term and the long term, or even last year,” Curtin notes, “the results are clear: Portfolio diversification still matters.”

An analysis of the returns for various asset classes in the past 10 years reveals that performance leaders change from year to year — underlining the importance of portfolio diversification, in Curtin’s view. “Because every environment has its winners and its losers,” says Curtin, “owning assets that move independently of one another can provide a valuable cushion for portfolios. Even during periods of widespread market turbulence, all of a portfolio’s holdings aren’t likely to be heading downward together. While some assets might be declining in value, others might be edging sideways or rising.”

If diversification across asset classes is important, so is diversification across geographic regions. During the past 10 years, there were times when emerging-markets equities outperformed developed-markets equities. At other times the situation was reversed. The same was true of international equities and domestic equities. Interestingly, in a recent U.S. Trust study comparing how 15 countries performed within a 10-year period, the United States (as represented by the S&P 500) finished in the top five 30% of the time but failed to finish first in any single year. “If history is any guide,” Curtin says, “portfolios with a substantial home-country bias could miss out on attractive returns overseas.”

The upshot? Investors can benefit from genuine diversification — that is, diversification among and within both asset classes and geographic regions.

RISK BUDGETING CAN HELP ENHANCE RETURNS

“No matter where you’re invested — whether with active managers or in passive strategies — your portfolio is subject to risk,” says Curtin. “That’s the way it should be, as the very purpose of investing is to assume risk in order to obtain a return. At U.S. Trust, we tailor the overall levels of risk to the specific

risk budgeting, which can help to optimize the different types of risk within a portfolio.”

LIQUIDITY BUDGETING FOR CASH FLOW IN ALL CONDITIONS

Closely related to the overall risk/return tradeoff is a portfolio’s liquidity, says Curtin. Liquidity is always an issue, and, as obvious as it may sound, cash is still king when it comes to liquidity. He recommends that investors set aside sufficient cash for meeting day-to-day needs. “As a rule of thumb, we recommend that clients place the

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goals and risk tolerances of each of our clients, and then adjust those levels as the goals and risk tolerances evolve.”

But that’s not all. Curtin believes it’s also essential to consider the many different types of risk that can be incurred. Beyond specific client characteristics, different market conditions call for assuming more of one type of risk than another. In a market where almost everything is suffering, for instance, managers may elect to invest further from their benchmark — incurring what is known as active risk — in their quest for higher-than-market returns. Alternatively, in an up market that seems to be lifting all investments, a manager would feel less compelled to increase active risk by stepping away from the benchmark and instead would emphasize “passive” risks — risks more dependent on the behavior of the market than on specific portfolio actions.

“The bottom line,” says Curtin, “is that risk can be measured, attributed and allocated through a process called

first several years of cash flow needs into a liquid portfolio to meet cash flow obligations as they come due,” he says.

“Beyond that, we help clients through a liquidity budgeting process based on historical experience, scenario analyses and sophisticated modeling and simulations that quantify the probability of meeting cash flow goals,” Curtin says. “We then periodically monitor liquidity levels to help ensure that our clients have sufficient reserves.”

ASSET LOCATION MATTERS

“At U.S. Trust, we believe that effective asset allocation requires effective asset location,” Drossman says. “That is, the worlds of investments and wealth planning need to be integrated. We do this by bringing together a team of highly experienced portfolio managers and planning professionals with deep expertise in income tax and trust and estate planning.”

But what is asset location? Says Drossman: “Once a client’s investments are selected, we need to decide on the best

‘locations,’ or types of accounts, in which to house each of those investments. We can think of wealth in terms of buckets. These buckets are filled with assets earmarked for particular purposes (for example, retirement, education and philanthropy). Within

philanthropic and wealth-transfer objectives may well take precedence over taxes,” he says.

Whatever the specific objectives, asset location is really about effective implementation of an asset allocation plan, in Drossman’s view, and it occurs in three

forced what we have always found to be true: Asset allocation and diversification can provide measurable benefits to investment portfolios. But this was not only true last year; it has also been true over much longer periods, and we believe it will continue to be true. At the same time, we recognize the need for nimbleness and flexibility. For us this means a dynamic asset allocation approach that balances the strategic (longer term) and the tactical (short term).”

Curtin believes that a well-conceived asset allocation should not only be comprehensive and holistic, fully diversified among geographies and asset classes, budgeting for both risk and liquidity, and integrating investments and wealth planning; it should also be customized to each client, and it should change as the client’s situation changes. Curtin explains: “We think the most important first step in creating an effective asset allocation is a conversation with your advisor — actually, a series of ongoing and detailed conversations — about your overall financial situation, your current investments and, most important, your needs and goals. In light of the past year’s events, imminent tax law changes and our investment outlook, we believe now is a critical time to begin these conversations.” ■

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each bucket we often find a variety of accounts, or asset locations. These may include taxable, nontaxable and tax-deferred accounts. They may also include trusts, limited partnerships and other structures with unique legal and tax characteristics.”

The goal is to optimize the overall asset allocation by selecting the most appropriate location for each investment. This is critical to maximizing the overall tax efficiency of an investment portfolio, and it can have a material impact on after-tax returns and long-term wealth accumulation. “After all,” Drossman says, “the returns that investors actually get to keep are not only net of fees but also after taxes.”

Asset location is clearly important, but it becomes all the more so in the rising-tax-rate environment that Drossman is anticipating. The temporary tax reductions enacted in 2001 and 2003 are scheduled to “sunset” at the end of 2010. Even more likely is the passage of new legislation that would increase marginal tax rates for high-income taxpayers.

But tax efficiency is often not the sole consideration — or even the most important one — for determining an appropriate asset location. “Particularly for wealthy individuals and families,

basic steps. The first step is to define the tax characteristics and tax efficiency of the investment returns. The second step is to understand the different types of accounts that can hold the assets — regular taxable accounts or various tax-deferred accounts. Wealthy families and individuals almost always need to consider additional places to hold assets — often various types of trusts — for their charitable giving and wealth transfer goals. The final step is the strategy’s effective implementation.

NOW IS THE TIME TO SPEAK WITH ADVISORS

“For all of its seeming anomalies and extremes,” says Curtin, “last year rein-

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Economic or financial forecasts are inherently limited and should not be relied on as an indicator of future investment performance. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. Diversification does not ensure a profit or guarantee against loss. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

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