REPORT & COMMENTARY

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TO: **CLIENTS & FRIENDS**
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Generally, the older you get the stickier your assets become. The reasons? Over time, people tend to become comfortable with what they own. Under-performing or losing assets are sold off. Less and less money is invested in speculative deals. In effect, the good quality stuff is what remains and people, rightly, tend to hold on to what is familiar and what has worked.

There is also the matter of taxation. As your long-term holds get longer, your unrealized gains tend to increase. This leads to a paradoxical consequence. The more successful the investment the greater the incentive to hold, at least if your low basis asset is owned in a taxable account. Any temptation to sell in a hot market is countered by the realization that the associated tax cost may well exceed any realistically estimated decline in price should there be a market correction.

My own considerable experience suggests four rules when it comes to long-held assets.

1) Just because an asset is selling at or near a high doesn't mean it may not still have legs. If the conditions that governed its progress to date still apply, then this is a reasonable expectation.

2) The devil you know is better dealt with than the devil you don't. In practice this means, among other things, there is always a reinvestment risk with sale proceeds. This is less the case should you be moving from a managed securities account (mutual fund, ETF) to another managed account. It emphatically is the case if you have decided that a real estate trade offers you the opportunity to increase your return on equity while deferring tax on the trade. At any given time, only a few readers will actually be interested in a real estate trade so I won't elaborate here on the advantages and (often downplayed) disadvantages of this subject, but will simply remind you that if and when you are contemplating this possibility give any of the WEIL advisors a call for a review. In this case, the devil really is in the details.

3) A relatively few long-held assets can represent a significant percentage of your net worth. "Concentration," said economist Maynard Keynes, "is the secret of economic success." Yes, but as they teach you in Financial Planning 101, "Diversification" (primarily of asset classes) "is the key to successful long-term investment." Who are you going to believe? As is the case with so many issues in life ... it depends. We all know people, and there are some among our readers, who are very well-to-do <u>and</u> whose businesses constitute material percentages of their net worth. They have learned to live and prosper with asset concentration and are poster children for Keynes. So, by analogy, if you are concentrated in assets that you have lived with long term (and the "innards" of which you understand as well as you know those of

your own children) and are confident that in a serious emergency (arising from either exogenous or endogenous sources) you could recover a respectable percentage of their value ... then, fine. If these conditions don't obtain, and you are uncomfortable with concentration, begin to plan for a slow and steady course of diversification. There are two ways to do this. If your concentrated positions are in marketable securities, you could plan to keep your concentrated positions but embark on an investment plan in which all sources of surplus cash flow are earmarked for assets diversified away from these holdings. This will result, in due course, in those concentrated positions representing less and less of your total assets. In the alternative, you could set a target date (perhaps as far out as two or three years) by which time you plan to have your concentrated positions reduced to a less "impressive" size, and then begin, say monthly, to sell down toward that chosen size. The longer-term selling runway will mitigate the tax burden (although note that current proposals to increase capital gains rates could tank any mitigation). There are also option strategies that can, to some extent, soften the costs associated with diversifying. Incidentally, if your concentration is in real estate holdings there may be a compelling argument for a tax-free exchange (or, more accurately, a series of tax-free exchanges in which your one big holding exchanges into a number of smaller holdings). It is complex but, with proper advance planning, it can be done.

4) The trend line is your friend, assuming it's going in the right direction – and you wouldn't be owning assets, at least not for long, where the trend line is going in the wrong direction (unless, that is, you're a member of the school of thought that believes you can't sell until your selling price equals or exceeds the price you paid). Ignore volatility. When your assets are "overpriced" the market reflects (often) undue optimism. When your assets are "underpriced" the market reflects (often) undue pessimism. For a good quality asset, the long-term price trend line should reflect the performance of the asset in accordance with reasonably well understood metrics, through good economic times and bad. Daily, weekly, monthly, even yearly price ranges, whether for individual assets or aggregated into indices and averages, tend to reflect the (euphoric, despondent, confused) passions of the shorter-term moments.

And speaking of long-term investment holds, you may be surprised at the extent to which long-term-investment-hold strategies contribute to income inequality (or more properly, to wealth inequality given that income is a function of the capital (current or expected) available to produce it).

Let me set the stage with two examples that illustrate this.

You own an income property bought in the mid '90's:

Price:	$500,000	
Equity down:	$150,000	
Loan:	$350,000	*(6% interest, 25-year amortization)
Debt service:	$27,000	per year
Rent collected:	$60,000	per year (based on 95% occupancy)
Expenses/CapEx reserve:	$30,000	per year
Net operating income:	$30,000	per year (before debt service and depreciation)

* Yes, I know that you were unlikely to get a 25-year amortizing loan without a 10-year call, but you can achieve the same result by refinancing the then loan balance at the end of years 10 and 20, each for a new 25-year amortization term. Assuming no change in interest rates or debt service, your loan would be fully amortized in 25 years. In the real world, your rates would have gone down in years 10 and 20.

Note the price paid was based on a 6% capitalization rate. Another way of saying this is that the buyer was willing to pay a price ($500,000) on which the net operating income before debt service and depreciation resulted in a 6% ($30,000) cash flow (not taxable income, because items such as depreciation and amortization of capital expenditures have not been included).

Depending on such things as property location and condition, this looks like a pretty good deal. Annual cash flow (net operating income less debt service) of $3,000 (or 2% on equity) is not bad considering the 70% financing. Cash flow would almost certainly be negative in today's world.

Fast forward to today. The loan is paid off:

- At 3% per year average increase in rents, current rental income is $125,600.
- At 3% per year average increase in expenses, current expenses are $62,800.
- Annual cash flow to owners: $89,800, say $90,000 (net income plus foregone debt service).
- Property value +/- $1,800,000*

* Capitalization rates have come down in the last 25 years, which means values have gone up. What you bought at a 6% cap rate is now selling at a 5% or less cap rate. As your net operating income today is $90,000 (that is the amount you, or a buyer, would net if the property were debt free), $1,800,000 is that purchase price of which $90,000 is 5%. I have oversimplified this example for illustrative purposes. Any buyer would insist on certain adjustments to expenses (property tax increase on sale is an example, which would increase the operating expenses and so decrease net income). But you get the point I am trying to make.

$150,000 for an equity down payment was a big number in 1995. But for those who had the ability to invest that amount (whether in this deal or something similar) the consequences were clearly attractive. You can imagine a family with spouses aged around 40, enjoying an employment income supplement from this investment during their earning years and then a $90,000 first-retirement-year income supplement with prospects for further rental income as rents and so cash flow rise.

Case Two involves the now well-known use of Roth IRA's to house the shares of either early-stage venture capital investments or founders shares, or both.

If you have the foresight, when starting a company that you hope will ultimately mature into a successful barn burner, and assign to yourself a passel of founders shares at a *de minimus* cost; and if you are patient; and if your company does in fact turn into the hoped for barn burner; and if you had the good sense, when starting your company, to concurrently open a Roth IRA account, invest a few thousand dollars into it and cause the IRA to acquire the founders shares; then you could end up with a $5 billion Roth. At least you could have until now, for almost certainly the provision in the current tax proposals that would curb this practice will pass.

As it should. If someone is enterprising enough to found a company, and live with the pain and suffering necessary to bring it to maturity, then let him or her by all means cash in at the end, for whatever the market will pay. But if the tax playing field were at all level, half of that $5 billion would have gone to help pay for roads and bridges. It is not "enterprise" alone that achieved this singular outcome. It was enterprise and a creature of legislation, one that just happened to be available for exploitation at inception and that effectively doubled the entrepreneur's financial outcome. Let investors of every stripe benefit from their enterprise, their skills, their luck, their courage, even their greed ... but a gift from government on top of the fruits of their labors, or their foresight, or their luck? Bah, humbug!

You will have noticed that my model real estate investment and the "gift" Roth IRA share certain features in common. The owners of each had access to opportunities. Each owner experienced substantial increases in asset values. In both cases there existed substantial capital to kick start their investments: $150,000 in the case of the real estate investor, less than $10,000 in cash in the case of the IRA investor but an enormous amount of intellectual capital (an available network from which to select the opportunity combined with the skills to select out a promising one; the clout to obtain a material quantity of founder's shares at virtually no cost; the contacts to promote add-on financing; etc.).

In fact, these common features (access to deals and availability of capital) have accounted for much of the economic opportunities that investors, as a class, have experienced in recent decades. When these opportunities are enacted in a context of generally rising equity prices, you have the phenomenon of substantial wealth increases across the board – except for those who start with no capital and have no access to capital along the way.

I said above that long-term investors have contributed to wealth inequality. Actually, my comment was something of a tease. If I start with $1.00 and over the long term grow my $1.00 to $3.00, and you start with $1.00 but, because of your circumstances (low wages, inadequate education, periodic layoffs, excessive medical bills, calls on your money for family support, the list goes on) have to spend that $1.00 and end up with nothing, then my relative success has "contributed" to a wealth gap between us. But to say my success is the "cause" is far too facile. It may be true as a matter of arithmetic, but it provides no insight into why (and the extent to which) the wealth gap constitutes a serious social and economic issue. The arithmetic is worth noting only because, so often, the press will focus on the successes of long-term investors as if these were somehow causal. They rarely are. And in dealing with issues of any kind, particularly one as serious as the wealth gap, if you begin with the wrong diagnosis, you will inevitably choose the wrong cure. And if you think my example of a long-term investor who turned a few thousand dollars into $5 billion is hardly just "arithmetic," I would agree with you, but with two caveats. First, this is one of those rare exceptions that proves the rule; and second, the villain of the piece is not the investor so much as it is the enabling legislation. Government sponsored tax "favoritism" has done infinitely more to widen the wealth gap than the aggregate behavior of investors.

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