Investment Planning Answer Book by Jay L. Shein, Investment Tools and Vehicles

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There are many investment tools and vehicles that are available to assist the investment advisor in managing the investor's wealth. Neither the investment advisor nor the investor should ever conclude that there is only one tool or vehicle that works. Consideration of many of these items will best serve portfolio design.

Investment Planning Answer Book by Jay L. Shein, Q 2:1, What type of cash and cash equivalent investments are available?

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Cash equivalent vehicles are highly liquid and highly marketable. Generally, they are safe and can be called upon in a short period of time. They include investments such as short term Treasury bills, short term certificates of deposit, money market funds, money market accounts, and savings accounts. They can be used to fund short term needs or in a diversified investment portfolio, to reduce investment risk. The investment advisor should be cautious when looking at investments that are being marketed as cash equivalents but which may not provide the marketability or liquidity desired. There have been mutual funds, structured products, and derivative strategies that have been marketed as substitutes for cash equivalents. Investment advisors should be cautious when using these investments as a cash equivalent. While some of these may have merit, they are usually best suited for another asset class such as bonds.

Cash equivalent type investments may provide stability and reduce volatility for short and intermediate periods of time, but they do expose the portfolio to additional purchasing power risks over longer periods of time.

Investment Planning Answer Book by Jay L. Shein, Q 2:2, What are some of the characteristics of fixed income investments?

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Fixed income investments usually pay a fixed interest rate or dividend. While they do have higher risk than cash equivalent investments, they also have higher returns. They also act as a diversifier when added to a portfolio as they are not highly correlated with many other investments or asset classes. As long as the issuer of a fixed income/bond investment does not default, the issuer will pay the interest/coupon payments and the principle at maturity.

Investment Planning Answer Book by Jay L. Shein, Q 2:3, What are some types of fixed income investments?

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- Long, medium, and short term U.S. government bonds
- Long, medium, and short term corporate bonds
- Long, medium, and short term municipal bonds
- Long, medium, and short term high yield bonds, sometimes referred to as "junk bonds"
- Foreign bonds of developed countries
- Foreign bonds of emerging markets
- Auction Rate Preferreds

Investment Planning Answer Book by Jay L. Shein, Q 2:4, What are some bond considerations?

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Bonds typically have a lower risk than stocks when measured by standard deviation, but they are riskier than cash equivalents. While fixed income investments/bonds as an asset class have more risk than cash equivalent vehicles, they will reduce the risk of a diversified investment portfolio due to the fact that they are not perfectly correlated with other asset classes. Some of the risks associated with bonds include purchasing power risk, default risk, and interest rate risk. Changes in interest rates, especially large changes, can significantly reduce the value of fixed income investments in a portfolio.

U.S. government bonds are the safest, but under normal conditions, they will have a lower return than corporate bonds or foreign bonds. U.S. government bonds are backed by the full faith and credit of the U.S. government and are considered risk free when held to maturity. If the return of investor's money is paramount relative to the return on the money in their fixed income investments, then U.S. government bonds would be the preferred choice. However, a fixed income portfolio consisting of all the various types of fixed income investments mentioned above is most likely to have a higher return and less risk when all factors are considered. Additionally, by adding diversified fixed income investments to a portfolio of other asset classes such as stocks, commodities, real estate, and alternative investments should enhance the risk reward tradeoff for a diversified multi-asset class portfolio.

When using bonds other than U.S. government bonds in a portfolio, the credit quality of the issuer or the country is important. Popular credit reporting services for bonds are Moodys, Standard and Poors, Fitch, and Egan-Jones. Once bonds are purchased for use in a portfolio, the stability and credit of the issuer must be monitored. An alternative to the investor monitoring individual bonds would be to hire a separate account manager or use a bond mutual fund. In smaller portfolios, it usually does not make sense to buy individual bonds since it will be difficult to diversify that asset class. Many times, a mutual fund and/or separate account manager will allow the portfolio to have multiple bond strategies included in the portfolio. In the last few years, the advent and popularity of bond exchange traded funds (ETFs) have made them a valuable investment vehicle to use in portfolios. They allow the implementation of various bond strategies without all the challenges associated with buying individual bonds. Currently, bond ETFs are available for government, municipal, and corporate bonds. The future may bring foreign bonds of developed countries and emerging markets into the ETF universe. Some of the providers of bond ETFs are the following: Barclays Global Investors, State Street Global Advisors, Vanguard and PowerShares.

Investment Planning Answer Book by Jay L. Shein, Q 2:5, What is the difference between common and preferred stock?

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Common stock is representative of an interest that investors own in a corporation. Common stock is typically considered an investment that can offer both capital growth in the long term and possibly dividend income. Common stock is typically included in a portfolio for investors that seek higher returns than fixed income securities in order to keep pace with inflation. Over the long run, stocks have provided higher returns than fixed income investments. An investor should note however that just because stocks have had higher returns on a historical basis, this does not mean that investors will actually experience higher returns with stocks in the future. Investors can find long periods of time when diversified common stock portfolios have had only slightly positive returns or even negative returns. Common stocks have some tax advantages if held for more than one year as currently they would be treated as a long-term capital gain and be subject to a maximum 15 percent tax. Stocks can also benefit from currently qualified dividend payments that are taxed at maximum of 15 percent. Day to day fluctuations of common stock values can be very high and are subject to business and financial risk if investing in an individual stock and are exposed to market risk if investing in a diversified portfolio of stocks.

Preferred stock has some of the attributes of a fixed income/bond investment and some of the attributes of common stock. Normally most preferred stock does not carry voting rights while common stock does. Preferred stock dividends must be paid before stock dividends are paid. Many times preferred stock issues are appropriate when a fixed income and a consistent cash flow are indicated. Preferred stock does have interest rate risk, market risk and financial risk. In 2008, investors saw large declines in the preferred stock values because of economic conditions. Preferred stock is not considered senior debt of the issuing entity. If there are credit problems with the company or throughout the capital markets, as has been seen in 2008, preferred stock will perform poorly. The senior debt holders will be the first to be paid in the event that the issuing corporation goes out of business. Preferred stockholders would be paid after bondholders and other creditors. Some preferred stock dividends are taxable as ordinary income, and some are considered qualified dividend income and are taxed at a lower rate.

Investment Planning Answer Book by Jay L. Shein, Q 2:6, What are some of the characteristics of options, warrants, and rights?

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Options, warrants and rights are derivatives that are traded in the securities markets. The term derivative indicates that this instrument derives its value from some other investment. Derivatives can also be a derivative of other derivatives. Many advisors and investors see derivatives as a speculative or high-risk investment. Although some derivatives might be considered speculative investments, many derivative strategies including certain type of option strategies can actually enhance or protect an investment portfolio.

A call option gives the purchaser of the option the right to buy a security at a specified price sometime in the future. One call option contract gives the purchaser the right to buy 100 shares of specific security at sometime in the future. The person who sells the call option to the purchaser is called the call writer or the seller of the call.

EXAMPLE 2-1

Assume that John believes that XYZ stock, which is currently valued at $50 may go up to $80 a share. John does not want to invest directly in the stock since he is uncertain that the stock will go up. John could buy a call option with a strike price of $60. The strike price is the price at which John could actually purchase the stock. Therefore, because John purchased a call option at $60, he is guaranteed the right to buy XYZ stock at $60 a share no matter how high the value goes. John's initial expense is only the premium he will need to pay to purchase a call option. We will assume in this situation that John purchased one call option contract for $300 that expires in 90 days. John has the right to buy 100 shares of XYZ stock for $60 a share or $6000. If the stock rises above $60 per share before the call option matures, the option is said to be "in the money." John then has the ability to exercise his option and purchase the shares at $60 a share. He could then either hold the stock or immediately sell the stock at the current market price. If he sells the stock, John's profit would be the difference between the $60 share purchase and the current price of the stock minus $300 paid for the call option, minus any transaction and tax costs. If the stock does not go over $60 a share, then John will let the option expire at the end of the 90 days. John's total loss would only be the $300 plus any transaction cost to purchase the option. Had John purchased 100 shares of XYZ stock, which was currently selling at $50 a share, he would have $5000 at risk.

Buying a call option might be compared to putting option money down on a house that one is looking to purchase. If the price of the house drops in value the purchaser can walk away from the purchase and just lose their option money.

The purchaser of a put option can be viewed as buying insurance on an investment. A put option may be used to protect an individual stock or the market risk of a portfolio of stocks.

EXAMPLE 2-2

Ms. Sachs owns a portfolio of stocks that mimics the S&P 500. The current price of this investment is $100 per share and Ms. Sachs is concerned that the S&P 500 may drop in value if economic conditions do not improve. Ms. Sachs is willing to let her S&P 500 portfolio drop 15%. After that, she does not want to incur a loss. Ms. Sachs could buy a put option on the S&P 500 at $85 a share. If she were to buy this put option and the S&P 500 subsequently dropped to $70 a share before her contract expired, Ms. Sachs would have the right to sell her investment at $85 a share. If Ms. Sachs never had to exercise the option it would just expire worthless and all Ms. Sachs would lose would be the premium paid for the options plus transaction costs. The purchase of the put option could be viewed as purchasing insurance.

Investment Planning Answer Book by Jay L. Shein, Q 2:7, What is the difference between a buyer and the seller of an option?

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The risk to the buyer of a put or call option is limited to the premium paid plus transaction costs. Therefore, the risk to the buyer of an option is easily quantifiable and the risk can be determined in advance. The seller of an option is also known as the writer of the option. The seller of a put option expects an investment to remain relatively stable or decline slightly in the future. The seller of an option receives a premium from the buyer. If the stock does not decline in value, the seller of the put option keeps the entire premium.

Investment Planning Answer Book by Jay L. Shein, Q 2:8, What is a forward contract?

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A forward contract is an agreement between two parties in which one party, the buyer, agrees to buy from the other party, the seller, an underlying asset or other derivative, at a future date at a price established at the time of the contract.

Investment Planning Answer Book by Jay L. Shein, Q 2:9, Who are the parties in the forward contract and how is the contract settled?

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The buyer of the contract is considered to be the long and the seller is considered to be the short. In a forward contract, the net result is a zero sum game. In other words, when one party wins, the other party loses an equal amount.

At the time of settlement, a forward contract can be settled by cash or by delivery. In a cash settlement, the long and the short pay the net cash value of the position on the delivery date. In a settlement by delivery, the contract is settled by the short party delivering the asset to the long in exchange for the predetermined price that the long agreed to pay for the asset.

For example, a farmer may sell a forward contract on wheat to lock in the price for which he can exchange his wheat after the harvest. In this situation, the farmer is the short position and would require him to deliver the wheat at the time the contract is settled in exchange for the predetermined price.

While the example above makes sense for the farmer's situation, most forward contracts are settled on a cash settlement basis, especially when the underlying position would be difficult to deliver. If the underlying were the Wilshire 5000 Index, the short would have to deliver the long a portfolio containing each of the Wilshire 5000 stocks in a proportionate weighting to that of the index.

Investment Planning Answer Book by Jay L. Shein, Q 2:10, What are some risks associated with forward contracts?

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There is the risk as an investor that you may have been better off not entering into the forward contract. In the prior example in which the farmer contracted to sell his wheat at a predetermined price, he would benefit if the price of wheat fell below the predetermined contract price as of the time of expiration, but if the price of wheat were above the predetermined contract price as of the time of expiration and he is able to sell his wheat at higher price, he would have been better off to not enter the contract.

Another risk that a party entering a forward contract has to consider is default risk. This is the risk that either party in the contract may default. To continue with the example of the farmer, the long party is exposed to the risk of the farmer not delivering the wheat. Most forward contracts are structured so that if short party does not make delivery, the long would not be obligated to make payment.

Investment Planning Answer Book by Jay L. Shein, Q 2:11, Can a forward contract be terminated before the contract expires?

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Although forwards are usually structured with the idea that the participants will settle the contract at the time of expiration, the contract can be terminated before that time. Assume that during the course of the life of the contract, the long party decides that they no longer want to purchase the underlying at expiration. The long can re-enter the market and create a new forward contract, but this time acting as the seller. The contract would be structured to expire at the same time as the original dated forward contract. Since the price of the underlying may have changed since the original contract was established, the new contract will likely have a different price but will eliminate the exposure to the underlying asset.

To put some figures to this situation, assume that in the original contract, the long agreed to buy the underlying at $100. Before the original contract expired, the long party decided that they did not want any additional exposure to the underlying asset. To eliminate this exposure, they entered into a second contract, but this time acting as the short party. We will assume that at the time they entered into this contract, they agreed to deliver the underlying asset for $105. Assuming the original contract's short position delivers the underlying to the long party, the long party will pay the short party $100 and in turn pass the underlying on to the second contract's long position in exchange for $105, resulting in a net $5 profit.

Investment Planning Answer Book by Jay L. Shein, Q 2:12, What are some types of forward contracts?

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- Bond forward contracts
- Interest rate forward contracts
- Equity forward contracts
- Currency forward contracts
- Commodity forward contracts

Investment Planning Answer Book by Jay L. Shein, Q 2:13, What is a futures contract?

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A futures contract is an agreement between two parties in which one party, the buyer, agrees to buy from the other party, the seller, an underlying asset or other derivative at a future date at a price agreed on today.

Investment Planning Answer Book by Jay L. Shein, Q 2:14, What is the difference between a forward contract and a futures contract?

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Forward contracts are private contracts that are customized to the particular situation, whereas, a futures contract is a standardized contract that takes place on an organized futures exchange. Rather than the parties setting the terms and conditions of the contract like in a forward contract, the exchange determines these provisions for the futures contract. Because futures are a standardized contract, there is a secondary market on which they can be traded. Forwards are essentially unregulated contracts, while futures are regulated at the federal government level. In the United States, the Commodity Futures Trading Commission regulates the futures market.

Investment Planning Answer Book by Jay L. Shein, Q 2:15, Who are the parties in the futures contract and how is the contract settled?

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As with a forward contract, in a futures contract, the buyer of the contract is considered the long and the seller is considered to be the short. However, since futures transactions are traded on the exchange, a clearinghouse also exists as a party in the contract. The futures exchange guarantees to each party the performance of the other party through the use of the clearinghouse.

In a prior section regarding forward contracts, we discussed the potential for default risk by either party. In a futures contract, the parties do not have to worry about collecting from the other party since the clearinghouse ensures that the parties will be paid.

Since the clearinghouse does not want to take on the risk of gains and losses on the underlying, the gains and losses are settled on a daily basis. This daily settlement, also known as marking to market, is essentially like closing a forward contract at the end of each day and opening a new contract the following day and continuing the same process until expiration.

Investment Planning Answer Book by Jay L. Shein, Q 2:16, Are parties required to contribute money up front in a futures contract?

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Unlike a forward contract, both the long and the short parties in a futures contract are required to contribute a small amount of money with the clearinghouse. This deposit is often called the margin. As the contract is marked to market on a daily basis, the short and long parties' accounts are credited or debited based on the change in price of the underlying contract.

The funds that are deposited when the trade is established are the amount necessary to meet the initial margin requirement. Margin requirements on futures contracts should not be confused with the practice of borrowing money on margin to purchase additional investments. In a futures contract, the initial margin requirement does not have a borrowing component; rather, it is more like a down payment for the commitment to purchase the underlying at a later date. Futures margins are usually less than 10 percent of the futures price. These margins are set by the clearinghouse and are typically determined by the clearinghouse studying the historical price movements of the underlying position.

Since the investor is only putting up a small amount of money to gain exposure to a much larger position, there is a significant leverage impact. This would be comparable to having significant leverage in a piece of property.

EXAMPLE 2-3

Suppose an individual was able to acquire a piece of property for $100,000 and made a down payment of 10% (or $10,000) to acquire the property and took a mortgage for the remaining $90,000. If the value of the property grew to $110,000 (or appreciated by 10%), holding the mortgage amount constant, the investors' equity has actually doubled (from $10,000 to $20,000). The opposite holds true as well. If the value of the property fell to $90,000 (or depreciated by 10%), holding the mortgage amount constant, the investor has experienced a 100% loss since his equity in the property is now $0.

As margin account balances change (based on the daily settlement procedure), holders of margin accounts may be required to add money to their account. The clearinghouse requires that if the margin account falls below the maintenance margin requirement, an account holder will receive a margin call and must deposit sufficient funds to bring the account back to the initial margin requirement. This additional margin required to bring the account back to the initial margin requirement is known as the variation margin.

Investment Planning Answer Book by Jay L. Shein, Q 2:17, What are some types of futures contracts?

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Futures contracts are usually divided into two main groups:

- Commodity futures contracts
- Financial Futures Contract
    - Stock Futures Contracts
    - Bond/Interest Rate Futures Contracts
    - Currency Futures Contracts

Investment Planning Answer Book by Jay L. Shein, Q 2:18, What is a mutual fund?

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A mutual fund is a company that manages the combined funds of many investors by investing those funds in stocks, bonds, money market instruments, and other securities. The assets in which the fund can invest are described in the funds prospectus. In an open-end mutual fund, the investment company continually offers new shares and buys existing shares back.

Investment Planning Answer Book by Jay L. Shein, Q 2:19, What are some of the advantages of purchasing a mutual fund?

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1. **Diversification.** In a mutual fund, each investor holds their proportionate share of all the holdings in the fund. Since many investors may not have the resources to buy all the individual components of the mutual fund, they receive the benefit of having exposure to a large number of investments through this one vehicle.
2. **Professional management.** Investors often do not have the training, experience, or time to properly manage their investments. A mutual fund provides the investor with the expertise of the manager to make the decisions about what investments to purchase or sell and the timing of those decisions—of course within the stated restrictions of the prospectus.
3. **Liquidity.** Mutual funds determine a Net Asset Value (NAV) for the fund on a daily basis. Although there is no guarantee of the price that you will receive when liquidating a mutual fund position, mutual funds are designed to provide daily liquidity based on the closing NAV.

Investment Planning Answer Book by Jay L. Shein, Q 2:20, What are some of the disadvantages of purchasing a mutual fund?

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1. Costs. All mutual funds have some fees and expenses that are paid by investors. All funds have some ongoing costs associated with operating the fund. Some funds have a specific transaction cost to purchase or sell the investment and others require that you pay a sales commission when you buy, sell or exchange the fund.
2. Realized and unrealized capital gains within the fund. Purchasing a fund just prior to a capital gain distribution is likely to be detrimental to a taxable investor since they will be subject to the tax on the distribution even though they did not participate in the gains from the fund. The investor should also be aware of the unrealized gains in a fund before purchasing since this may translate into future realized gains for the investor.
3. Uncertainty of future value. Like many investment options, mutual funds do not provide any guarantee of future return, so the investor is subject to the risks of fluctuation in value of the fund.
4. Cash drag. Due to the fact that mutual funds must maintain liquidity and the capacity to accommodate withdrawals, the fund must keep some of the portfolio in cash. The cash portion of the portfolio may actually have a positive or a negative effect on the portfolio performance depending on the market fluctuations during the time period you are addressing, but it does have some effect and is therefore sometimes referred to as a cash drag on the portfolio.
5. May be difficult to evaluate. Unlike an individual stock, which an investor may evaluate based on the company financials, fundamental ratios, etc., a mutual fund holds many different stocks and those holdings may change on a frequent basis as positions are bought and sold by the manager which makes it more difficult for the advisor to evaluate.

Investment Planning Answer Book by Jay L. Shein, Q 2:21, What is a Separately Managed Account?

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A Separately Managed Account, or SMA, is an individual investment account managed by independent money managers typically managed under an asset-based fee structure. Although many types of accounts may fit the definition of an SMA, common characteristics include a fee-based cost, open investment choices, multiple managers, and a customized investment portfolio formulated for a client's specific needs.

Investment Planning Answer Book by Jay L. Shein, Q 2:22, Are SMAs more advantageous than mutual funds?

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Due to the fact that SMAs are able to be tailored to fit the specific needs of the investor, they do offer a higher level of customization than do mutual funds. In addition, any gains or losses from the SMA will be based on the period during which the investor actually held the assets which may not be the case for mutual fund positions. Some state that these vehicles improve tax efficiency, since depending on the client's needs, specific positions could be sold to realize gain or to harvest losses. In addition, some investors prefer the ability to see the individual holdings that are reflected on a separately managed account statement unlike a mutual fund which just reflects the mutual fund position.

However, in spite of these "advantages" there is still much debate as to whether SMAs actually provide significant advantages in terms of either risk/return parameters or even tax efficiency over extended periods of time. Due to the higher minimums often required to invest in these vehicles, they have enjoyed popularity among wealthier investors, but the evidence of them actually being better investment vehicles is not clear.

Investment Planning Answer Book by Jay L. Shein, Q 2:23, What is a Multi-Strategy or Multi-Discipline Account?

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A Multi-Strategy (or Multi-Discipline) account is an investment account that allows access to several specialized investment managers within one main account. The account is divided into separate sub-accounts in order to segregate the individual managers that are running their separate strategy.

Investment Planning Answer Book by Jay L. Shein, Q 2:24, When would you consider using a Multi-Strategy or Multi-Discipline Account?

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These accounts provide investors an efficient way to get professional investment management and asset diversification. These accounts may act as an alternative to SMAs since SMAs implement one type of management expertise per account, where the multi-strategy approach can have multiple disciplines divided into sub-accounts. Therefore, an investor may be able to obtain access to the multiple disciplines with a smaller investment size since the SMAs require sizable minimums for each investment strategy.

Investment Planning Answer Book by Jay L. Shein, Q 2:25, What is a Unified Managed Account?

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A Unified Managed Account (UMA) is a professionally managed private account that can encompass all types of investment vehicles (mutual funds, stocks, bonds, exchange traded funds, etc.). This eliminates the need for multiple Separately Managed Accounts if an investor desires to have a well-diversified portfolio containing many different types of assets and covering a variety of asset classes. The open architecture approach gives the investor a much broader range of investment possibilities.

Investment Planning Answer Book by Jay L. Shein, Q 2:26, What is an Exchange Traded Fund?

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An Exchange Traded Fund (ETF) is a pooled investment vehicle that is traded on a stock exchange, much like that of a stock. This investment vehicle allows an investor to gain access to a diversified mix of stocks (or other investment) through a single tradable share.

Investment Planning Answer Book by Jay L. Shein, Q 2:27, How are ETFs priced?

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The ETF's Net Asset Value (NAV) should be approximately equal to the value of its underlying assets at any given point in the day. Any mispricing would provide an arbitrage opportunity. For example, if a basket of securities was trading at $100, but the underlying positions were worth only $98, an investor could short the ETF —or essentially sell the basket—for $100, buy the underlying securities at $98, use the securities to cover the short position and be left with a riskless profit of $2.

Investment Planning Answer Book by Jay L. Shein, Q 2:28, What are the primary advantages of an ETF?

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Due to the fact that they can be traded on the exchange, the investor has more flexibility in the timing of entry or exit of these positions. Stop loss orders or buy limit orders can also be placed on these investments either to protect against the loss of decline or to allow for a market entry at the desired price. ETF shares can also be purchased on margin or sold short.

ETFs allow investors the ability to get diversified exposure at a low cost. Costs are lower than many investment vehicles since most ETFs are not actively managed and do not have some of the costs of buying and selling securities to accommodate shareholder purchases and redemptions.

ETFs are made up of transparent portfolios and are priced at frequent intervals throughout the day (typically every 15 seconds). The liquidity of the ETF is directly related to the liquidity of the underlying basket of securities that the ETF holds.

ETFs are considered to be a tax efficient way of investing. These vehicles generally have little, if any, capital gains due to usually low portfolio turnover and their unique creation-redemption feature which allows them to meet investor redemptions without having to sell investment positions.

Due to their increased popularity, a growing number of ETFs are being introduced giving investors many options on how to gain exposure to a particular investment style, geographic area, industry, sector, etc. Until recently, ETFs have traditionally tracked index funds and have been considered solely passive investments, but in 2008 the U.S. Securities and Exchange Commission began to authorize the creation of actively managed ETFs.

Investment Planning Answer Book by Jay L. Shein, Q 2:29, What is a creation-redemption unit?

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Financial institutions purchase and redeem Exchange Traded Fund (ETF) shares directly from the ETF in large blocks that vary in size by ETF from 25,000 to 200,000 shares called "creation units." Purchases (or redemptions) are generally made in kind, so an actual basket of shares is transferred in the same type and proportion to that of the ETF. This ability to purchase and redeem creation units helps ETFs to reduce any deviation from the market price of the ETF and the underlying positions held in the ETF. It also allows for improved tax efficiency since no positions need to be sold to process a redemption request.

Investment Planning Answer Book by Jay L. Shein, Q 2:30, What are some strategies that can be implemented with the use of Exchange Traded Funds?

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Exchange Traded Funds (ETFs) can be used to equitize a portfolio's cash position. If a manager receives a sizable cash flow and wants to gain market exposure until another decision is made, an ETF gives the manager a way to gain this market exposure easily and quickly.

ETFs can also be used in making tactical or strategic allocation decisions. An investor may consider using a passive approach with a portion of his portfolio and use ETFs to implement this strategy. Another investor may be interested in overweighting a particular industry or sector in the portfolio and can use an appropriate ETF to accomplish this portfolio tilt.

ETFs can also be used to manage an individual's taxes. For example, an investor who desires to maintain market exposure could harvest a loss in a particular stock holding and acquire an ETF with similar sector exposure. This transaction would not violate the Wash Sale rule which states that in order for an investor to take a tax loss, they can not buy an investment with a substantially identical economic exposure 30 days before or after the sale.

Another strategy would be to sell one ETF at a loss and replace it with another ETF. Depending on the ETF that is sold, the investor may be able to identify another ETF with similar, but not identical economic exposure. This would allow the investor to remain exposed to that segment of the market. An investor could also replace an actively managed fund with one or more ETFs that closely resemble the actively managed fund that was sold.

ETFs can also be integrated when transitioning out of an investors concentrated, low basis stock portfolio. A portfolio could be structured using sector ETFs to gain the desired exposure. As different sectors fluctuate in value, the investor can realize losses on positions that have declined in value to offset gains realized from the sale of the concentrated, low basis stock positions. This could provide a tax-efficient portfolio over time. Investors should always consult with a tax advisor when implementing any tax aware strategies.

Investment Planning Answer Book by Jay L. Shein, Q 2:31, What are some types of Exchange Traded Funds?

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1. Index ETFs. Most ETFs are index funds that hold investments that are designed to replicate the holdings and performance of a stock market index. Some ETFs accomplish this by holding exactly the same holdings as the underlying index. Other ETFs use a representative sampling to accomplish this objective.
2. Currency ETFs. An ETF that provides an investor exposure to the desired currency. The first currency ETF was launched in 2005 by Rydex Investments and was called the Euro Currency Trust.
3. Commodity ETFs. These ETFs invest in commodities, such as precious metals or futures. Among the earliest and most popular commodity ETFs were gold exchange traded funds.
4. Leveraged ETFs. These are ETFs that use equity swaps, derivatives, and rebalancing to achieve a leveraged ETF portfolio. Examples of leveraged ETF objectives would be to generate 2 or 3 times the return of some underlying index. Although these vehicles may have a place in an investor portfolio, caution should be exercised in properly understanding the effect of the leverage. See the following example to understand the impact of leverage in the portfolio.

EXAMPLE 2-4

Investor #1 decides to invest $10,000 in a 3 times Leveraged Bull ETF. Investor #2 invests $10,000 in a non-leveraged ETF on the same index. On day 1, the index increases by 10%, so the non-leveraged investor also increases by 10%. The leveraged ETF increases by 3 times the amount. Therefore, after day 1, Investor #1's position is worth $13,000 while investor #2's position is worth $11,000. On day 2, the index declines by 10%. Investor #2's position falls by 10% and is now worth $9,900. Investor #1's position falls by 30% and is now worth $9,100. The impact of the leveraged portfolio in this scenario leaves investor #1 with roughly 8% less than investor #2.

Investment Planning Answer Book by Jay L. Shein, Q 2:32, What is an Exchange Traded Note?

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An Exchange Trade Note (ETN) is a senior, unsecured, unsubordinated debt security issued by an underwriting bank. ETNs are backed only by the credit of the issuer. The ETNs themselves are not rated, do not offer voting rights and most do not pay interest during the term of the ETN. They are designed to provide investors with a way to access the returns of market benchmarks or strategies. ETNs are not equities or index funds, but they do share several characteristics. For example, like equities, they trade on an exchange and can be shorted. Like an index fund, they are linked to the return of a benchmark index.

When held to maturity, the investor will receive a cash payment that is linked to the performance of the corresponding index during the period beginning on the trade date and ending at maturity, less investor fees. Typically, ETNs do not offer principal protection. ETNs could also be liquidated before their maturity by trading them on the exchange or by redeeming a large block of securities directly to the issuing bank.

Investment Planning Answer Book by Jay L. Shein, Q 2:33, What are the advantages of Exchange Traded Notes?

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ETNs are tax efficient investments due to the fact that there is no interest payment or dividend distributions and the realization of gains or losses is based on the investor's hold period. If held for at least one year, the sale proceeds would qualify for long term capital gain treatment. ETNs do not have any tracking error from the index. Although they track an index like an ETF does, the returns are not based on the underlying securities since the ETN issuer provides the investor with the exact return of the index minus any ETN expenses. ETNs also provide increased liquidity and access to hard to reach exposures such as commodity futures and foreign currencies.

Investment Planning Answer Book by Jay L. Shein, Q 2:34, What are some of the disadvantages and risks of Exchange Trade Notes?

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ETNs are subject to the credit quality of the underwriting bank that has issued the note. Although this risk may not be high, it is a risk that should be accounted for when purchasing the note. Although ETNs are being promoted with tax efficiency being a primary benefit, the newness of this structure has not been tested by the Internal Revenue Service and may be subject to change. If the IRS were to issue an unfavorable tax ruling, some investors may still participate in order to access segments of the market that would otherwise be difficult to reach, but without the tax efficiency, the growth of ETNs may be limited.

Investment Planning Answer Book by Jay L. Shein, Q 2:35, What are structured notes?

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Structured notes are financially engineered products that offer investors the ability to create a customized investment vehicle that is designed to give them the desired risk/return characteristics. The notes are usually senior, unsecured obligations of the issuer. Most structured notes are also registered securities where the issuer has filed a registration statement with the SEC for the offering.

These pre-packaged investment vehicles typically include derivatives to accomplish the desired result. The derivatives allow the investor access to a particular market or security without actually holding a long position in the underlying investment. They can be used to gain market-like return of indices, a basket of securities, a single stock, currencies, commodities, fixed income, and other desired exposures.

Investment Planning Answer Book by Jay L. Shein, Q 2:36, What are some types of structured notes?

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Structured notes usually fall into three different categories:

1. Principal protected notes
2. Yield enhancement notes
3. Out performance notes

Within these categories, the notes may be linked to interest rates, equities, credit markets, commodities, consumer price index, and other investment vehicles. Some examples of structures that are currently available include buffered notes, absolute return barrier notes, yield steepener notes, spread notes, and accelerated market participation notes.

Investment Planning Answer Book by Jay L. Shein, Q 2:37, How does a structured note work?

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Although there are a variety of structures to these notes, many are made up of a zero coupon bond plus a derivative on the underlying market to which the investors would like to gain exposure. One such structured note is a principal protected note.

EXAMPLE 2-5

To illustrate how this works, let's assume that an investor has $10,000 to invest and would like to gain market-like exposure to the Standard & Poors 500 Index without the downside risk of being invested in the Standard & Poors 500. The investor could protect his downside by purchasing a zero coupon bond that will mature at par. Since zero coupon bonds pay no dividends, the investor would purchase these bonds at a discount. The discount would be determined based upon the prevailing interest rates. If interest rates were currently 4% for a two-year treasury, an investor would allocated approximately 92% into the two-year zero coupon bond and would be able to invest the remaining 8% (less any fees paid to the agent structuring the product) into a call option on the S&P 500. A two-year call option would be purchased with a strike (exercise) price at the current value of the S&P 500. Therefore, if the S&P 500 declined in value, the investor would not exercise his call option, but would receive his full principal back at maturity from the zero coupon bond. If the S&P increased in value, the investor would exercise the call option to realize the appreciation and would also receive back his invested principal from the zero-coupon bond.

The amount of exposure the investor will gain to the underlying index is subject to a number of variables. As already mentioned, the prevailing interest rates will determine the amount of discount received on the zero coupon bond. In addition, the longer the maturity of the note, the more exposure the investor can get to the underlying security. In the prior example where a two-year zero coupon bond could be purchased at approximately $92 and mature at par, a five-year zero coupon bond could be purchased at approximately $80 (actually less than this when taking into account compounding), leaving $20 + for the allocation to the derivatives needed to gain the desired exposure.

The price of the option is also subject to change. In general, the options are more expensive when there is a significant amount of volatility in the underlying and is also dependent on the investor sentiment for the underlying. For example, if investors are heavily bearish on the underlying investment there will be low demand for the underlying, making it relatively cheap to purchase.

Investment Planning Answer Book by Jay L. Shein, Q 2:38, What is a buffered note and how is it used in a portfolio?

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A buffered note is a structured product that provides an investor with exposure to an underlying investment, but also some amount of protection (the buffer) on the downside. These differ from fully principal protected notes since they do not protect 100 percent of the investor's principal. In a prior example of a principal protected note, we assumed that an investor would buy a zero coupon bond that would mature at par and use any additional funds to purchase a call option at the current value on the underlying investment. With a buffered note, the investor is more willing to take some risk on the downside for the potential of achieving greater upside exposure. A typical structure of a buffered note may be put together in a way that the investor participates immediately on the upside but does not participate in the downside until after the underlying investment has declined by 10 percent.

The components of this structure are very similar to the principal protected note in that the investor still purchases a zero coupon bond that matures at par and buys a call on the underlying investment at the current price of the underlying. However, the investor also sells a put on the underlying index at 10 percent below the current price of the underlying. To see how this plays out, let's look at a specific example.

EXAMPLE 2-6

An investor would like to participate in the upside of the Dow Jones Industrial Average (DJIA) with $100,000 of his investment portfolio, but is concerned about the downside risk. He is willing to take some risk, but would like to avoid being fully exposed to the DJIA's downside. He decides that he is comfortable with a 10% buffer. (In other words, he does not want to participate in the first 10% decline in the DJIA, but feel that the risk of decline in the DJIA of more than 10% is low enough that they are willing to accept that risk after the first 10% decline). For simplicity purposes, assume that the DJIA is trading at 10,000. Based on the market conditions at the time of the purchase, the investor allocates $93,000 to a zero coupon bond that will mature in two years when it will be worth $100,000. He also sells a put option with a strike price of 9,000 on the DJIA (or a 10% decline from the current price). He receives a total of $4,000 as premium payment for the put option. Since he paid $93,000 for the zero coupon bond, but received $4,000 for the sale of the put option, he has spent a net total of $89,000 of the $100,000 he has to invest. He will then use the remaining $11,000 to purchase a call option with a strike price of 10,000 that gives him dollar for dollar upside participation on the DJIA. (For simplicity purposes, this example does not take into consideration any fees that would be paid to the issuer of the note).

Consider now the following potential outcomes of this note:

1. The DJIA closes at 8,000 at the date of maturity (down 20%)
2. The DJIA closes at 10,000 at the date of maturity (flat)
3. The DJIA closes at 12,000 at the date of maturity (up 20%)

In the first potential outcome, the investor would not exercise his call option since the closing price was below his strike price of 10,000. He would receive $100,000 from the maturing zero coupon bond; however, he would be obligated to pay $10,000 based on the put option he sold with a strike price of 9,000. (The buyer would exercise the right to sell the position at 9,000. The investor would be forced to buy this back at 9,000, even though he could only turn around and sell it for 8,000 (a loss of 10% of his original investment). This illustrates how the investor is shielded from the first 10% of downside on the DJIA, but shares in the downside thereafter.

In the second scenario, the investor would receive his principal back based on the zero coupon bond maturing, but he would not exercise the call—nor would the put be exercised since this option is out of the money. Our investor in this case would have no return (again not taking into consideration any fees or expenses related to the note).

In the third scenario, the investor would receive his principal back based on the zero coupon bond maturing, but would also exercise the call option to buy the DJIA at 10,000. With the value of the DJIA having risen to 12,000, the investor would see a 20% gain in his holding.

Investment Planning Answer Book by Jay L. Shein, Q 2:39, What are the advantages of structured notes and when might they make sense in a portfolio?

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Structured notes can provide a way for investors to gain exposure to an underlying investment while still having some downside protection. Depending on the cost of the components of the structured note, the individual may also be able to enhance returns by increasing the upside potential by more than 100 percent. For example, a note could be structured to provide an investor with 1 for 1 downside participation, but 2 for 1 upside participation with a cap on the maximum upside. Depending on the structure, these notes can also provide investors with reduced volatility with the potential outcomes for an investment limited to a tighter range of possible outcomes.

Structured notes can be beneficial for investors who are trying to create a customized vehicle to align with their specific views. They can provide ease of access for investors who do not feel comfortable structuring the note themselves or do not have the ability to do so. They may also be used to gain access to alternative investment classes that may be difficult to invest in directly.

Investment Planning Answer Book by Jay L. Shein, Q 2:40, What are the risks and drawbacks of structured notes?

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One of the biggest risks associated with structured notes is the credit quality of the issuer. Unless these notes are specifically structured as such, they are not federally guaranteed and are subject to the backing of the underlying issuer. Even though these notes are typically issued as senior debt (so they receive top priority in repayment), if the issuer declares bankruptcy, the investor could lose some or all of his investment principal, regardless of the performance of the structured note.

Market risk and liquidity risk are two other key risks that investors need to be aware of. Depending on the structure of the note, the derivates used to construct the note may significantly increase the volatility of the note's performance and subject the investor to principal loss. In addition, if an investor attempts to liquidate prior to maturity, the secondary market is limited. Therefore, a note may be sold for considerably less than the value stated for investors still holding the position.

One drawback that is common to most structured notes is that the upside appreciation on the underlying index does not usually include dividends. In other words, the investor's upside is limited to the price appreciation of the underlying investment—excluding any dividends paid on the underlying investment. Although some structured notes do provide investors the total return appreciation, most do not. Investors should always carefully review the prospectus, any prospectus or product supplements, and the term sheet for each specific structured note for additional information before investing in the note.

Investment Planning Answer Book by Jay L. Shein, Q 2:41, What is an auction rate security?

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An auction rate security (ARS) typically refers to a debt instrument for which the interest rate is reset in frequent intervals even though the auction rate security has a much longer term maturity. The process of resetting the interest rates is done through a Dutch auction. Auctions are typically held every seven, twenty-eight, or thirty-five days although some ARS have different reset periods. The interest is paid at the end of each reset period.

The interest rate is determined at the auction based on the number of existing bond holders that want to sell or hold their bonds at the minimum yield. Existing holders and potential investors enter a competitive bidding process in which the reset interest rate is determined. Each bid and order size is ranked in ascending order based on the bid rate. The lowest bid rate at which all the shares can be sold at par establishes the interest rate, also known as the "clearing rate." This rate is paid on the entire issue for the upcoming period. Investors who bid a minimum rate above the clearing rate receive no bonds, while those whose minimum bid rates were at or below the clearing rate receive the clearing rate for the next period. ARS shares are most commonly issued in denominations of $25,000.

During its 20-plus years of history, the auction market ran smoothly with very few auction failures until 2008. In February of 2008, most such auctions failed and the ARS market has been largely frozen since that time. Since the latter part of 2008, some investment banks that had marketed and distributed auction rate securities agreed to repurchase some of them at par. Although there is a secondary market to sell these bonds, it is currently limited in nature. Most vendors of ARSs are in the process of refinancing these securities and redeeming them. Many of these ARSs carry a AAA credit rating.

Investment Planning Answer Book by Jay L. Shein, Q 2:42, What are variable rate demand notes?

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A Variable Rate Demand Note (VRDO) is a high-quality, floating rate debt instrument that represents borrowed funds that are payable on demand to the lender. These notes accrue interest based on a prevailing interest rate, such as the prime rate. The interest rate is specified from the outset of the debt, and is typically equal to the specified money market rate plus an extra margin. Since this rate changes over time, the variable rate demand note typically provides some protection against rising short-term interest rates since these securities will adjust quickly to any changes. These are often structured in a way to provide tax-exempt interest. The actual note's maturity is usually long-term (often around 30 years), but the interest rate resets on frequent intervals. The put feature that is part of these notes provides a contractual source of liquidity through either a letter of credit or a standby bond purchase agreement. Therefore, if an investor determines that they no longer want to hold the note, they can "put" it back to the issuer and receive par plus any accrued interest at the next put date. Although these securities are not federally guaranteed and are subject to credit risk, interest rate risk, and general market risks, these investments are considered by many as a good, short-term investment alternative due to their high quality and strong liquidity.

Investment Planning Answer Book by Jay L. Shein, Q 2:43, What is a fixed annuity?

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A fixed annuity is an investment vehicle offered by an insurance company which guarantees a stream of fixed payments over the life of the annuity.

Investment Planning Answer Book by Jay L. Shein, Q 2:44, Who bears the risk with a fixed annuity?

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The insurance company bears the investment risk since they are required to pay an annuitant a fixed stream of income over the life of the annuity. The investor in a fixed annuity is not without risk though. One risk that the investor bears is that the annuity payments are backed by the insurance company and could cease if the insurance company were to default. The investor is also subject to the lost opportunity cost since there is no appreciation potential on the assets invested in the annuity. One of the greatest risks of a fixed annuity may be the impact of inflation. Depending on the level of inflation, the purchasing power of a fixed annuity payment could be significantly eroded over an extended period of time. Although some fixed annuities provide for an increase for inflation, they will pay a lower initial payment to account for the future increases due to inflation.

Investment Planning Answer Book by Jay L. Shein, Q 2:45, What is a variable annuity?

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A variable annuity is a contract offered by an insurance company that can be used to accumulate savings on a tax deferred basis. The investor is able to allocate any contributions (premium) among a number of sub-accounts or investment portfolios offered through the contract. The contract value, which fluctuates over time, reflects the performance of the underlying investments held by the funds that have been selected, minus the contract expenses. All withdrawals from qualified annuities are taxed as ordinary income, rather than at the lower capital gains rate. If you make withdrawals before you reach age 59½, you may also be subject to a 10 percent early withdrawal penalty. Payments made to non-qualified annuities after August 14, 1982 (considered post-TEFRA contributions), can only be withdrawn after all income/gains have been distributed first. Therefore, all distributions are treated as ordinary income until everything but the cost basis is left in the policy. Payments made to non-qualified annuities prior to August 14, 1982 (considered pre-TEFRA contributions), can be withdrawn prior to the earnings/gains in the contract.

Investment Planning Answer Book by Jay L. Shein, Q 2:46, Why might you consider a variable annuity?

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1. **Tax deferral of investment gains**. Just like an IRA, your contributions and earnings can grow tax-deferred until you start to withdraw funds.
2. **Ease of changing investments**. Because variable annuities have sub-accounts with various investment options to select from, it's easy to change investment direction at little or no cost to the investor.
3. **Income for life**. Once you select monthly payments (or annuitize) from your contract, the insurance company will guarantee you (and your spouse, should you desire) the income payment for the rest of your life or some predetermined period of time.
4. **Asset protection**. In certain states, annuities are a shelter from creditors. If you work as a physician or in an economically hazardous occupation, they may be a great savings tool.

Investment Planning Answer Book by Jay L. Shein, Q 2:47, What are some of the drawbacks to variable annuities?

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1. **Irreversible decision.** Once the decision has been made to annuitize your contract, the decision can not be changed.
2. **Risk of not getting your money back.** If an annuitant selects a life-only option on his annuity income stream, he is taking the risk that he will live long enough to get his principal returned to him. If he were to die within a year and held a life-only option, he would forfeit any future payments.

   PLANNING POINT 2-1

   Other options can be elected to avoid this risk. Examples would include joint and survivor payouts with a spouse, or payments based on the annuitant's life and a period certain where payments are guaranteed to the annuitant and a designated beneficiary for a certain period of time. Another example would be a return of premium option. Although these options provide some protection against the risk of losing principal, they typically come with a cost—either by way of reduced payment benefits or increased costs associated with the ongoing fees within the annuity.
3. **Potential withdrawal penalties.** Once funds are contributed to an annuity, they cannot be withdrawn until the account owner has reached the age of 59½. If withdrawn prior to this age, they are subject to a 10 percent early withdrawal penalty.
4. **No benefit of capital gains or losses.** When distributions can be made from an annuity, any amounts in excess of basis are taxed as ordinary income—even if the gains were due to long term capital appreciation of stocks—which would typically be taxed at a lower capital gains rate if held outside the variable annuity. In addition, the investor cannot receive any tax benefit from positions that were sold at a loss.
5. **Surrender charges may apply.** Insurance companies often have hefty surrender charges if an account owner wants to quickly withdraw funds from an annuity. Surrender fees often start around seven or eight percent in year 1 and decline to 0 percent after a seven or eight year period, but some may have higher surrender charges and even longer periods before they are surrender charge free.
6. **Commissions.**Since these annuity products are often sold on a commission basis, these commission-based annuities will usually increase annuity costs that will detract from investment returns. These commission-based variable annuity products tend to have some of the highest variable annuity fees and costs imbedded in them.
7. **Annual fees, administrative charges, and mortality and expense charges.** These costs are often less visible in the contract, but may between 1 and 3 percent of the contract value on an annual basis reducing the growth potential of the investor's funds.
8. **Appreciation above basis subject to income in respect of a decedent.** If an individual dies while owning an annuity whether variable or fixed, it will be subject to income in respect of a decedent on amounts over basis in the annuity. This income is income the decedent would have received had death not occurred that was includible on their final income tax return. The individual who receives the income (amounts over basis) e.g., such as a decedent's surviving 25-year-old son would have to declare the income on their income tax return when received.

Investment Planning Answer Book by Jay L. Shein, Q 2:48, What is the difference between an immediate annuity and a deferred annuity?

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With an immediate annuity, the investor makes a lump-sum deposit, and the insurance company guarantees an immediate monthly payment until the annuitant's death and/or a specified period of time. The monthly amount is based on the annuitant's life expectancy and/or a specified period of time. With a tax-deferred annuity, you invest your money and watch it grow tax-deferred until you decide to take out your money.

Investment Planning Answer Book by Jay L. Shein, Q 2:49, How does life insurance fit into an investor's situation?

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Many individuals are confronted with the question of how life insurance should be used for an individual's situation and whether or not it is beneficial as an investment. Since situations may vary by individual, there is no one solution to all individual's needs. The best approach to answering these questions is to be familiar with the vehicles that are available and the pros and cons to using them. It is also important to make sure that the individual's primary needs and objectives are being met.

Investment Planning Answer Book by Jay L. Shein, Q 2:50, What policy options are available when purchasing life insurance?

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There are two main types of insurance: term insurance and cash value insurance (sometimes referred to as permanent insurance). Cash value can be broken down further into five different categories.

1. **Term Insurance.** This is the cheapest form of insurance that has no cash value/investment component to it. Premiums are paid on an annual basis to keep the policy in force. The only benefit received from the policy will be the death benefit if the insured passes away. Term policies may be purchased that have level premiums for a specified number of years, but at some point the premium will adjust and may be significantly higher at the time of adjustment.
2. **Whole Life Insurance.** This is a type of permanent life insurance that, as long as the premiums are paid, can cover the policyholder over the course of their entire life. Premiums usually remain level with this type of policy. A savings component, called cash value or loan value, builds over time and can be used for wealth accumulation. This is typically the most expensive form of life insurance. There are several types of whole life insurance including: non-participating, participating, indeterminate premium, economic, limited pay, and single premium. With a typical whole life policy, the death benefit is limited to the face amount specified in the policy, and at endowment age, the face amount is all that is paid out.
3. **Universal Life Insurance.** This is another type of permanent life insurance based on a cash value. In this type of policy, the insured makes premium payments to the insurance company. The portion of the premium payment that exceeds the cost of the insurance is added to the policy's cash value. The cash value is credited each month with interest, and the policy is debited each month by a cost of insurance (COI) charge and any other policy charges and fees which are drawn from the cash value if no premium payment is made that month. The interest credited to the account is determined by the insurer; sometimes, it is pegged to a financial index such as a bond or other interest rate index. This type of policy gives the insured the flexibility to adjust the insurance premiums—or even skip some premium payments—as long as there is sufficient cash value in the contract to cover the cost of insurance.
4. **Variable Life Insurance.** Variable life insurance is a form of whole life insurance under which the death benefit and the cash value of the policy fluctuate according to the investment performance of a separate account fund. Most variable life insurance policies guarantee that the death benefit will not fall below a specified minimum. A minimum cash value is seldom guaranteed since the policy owner assumes the investment risk for the investments selected under the contract. Variable life insurance policies are considered securities contracts. In the United States, variable life insurance policies must be registered with the Securities and Exchange Commission (SEC).
5. **Variable Universal Life Insurance.** This type of insurance (often referred to as a VUL), is a combination of the Variable Life Insurance and the Universal Life Insurance contracts referenced above. The universal component allows for flexibility in the insurance premiums and the variable component allows for investments in sub-accounts that affect the value of the cash value within the contract. This is a type of permanent life insurance, since the death benefit will be paid if the insured dies at any time as long as there has been sufficient cash value in the policy to pay the cost of insurance in the policy.

Investment Planning Answer Book by Jay L. Shein, Q 2:51, What is a Real Estate Investment Trust (REIT)?

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A Real Estate Investment Trust (REIT) is a corporation, business trust, or association managed by one or more trustees or directors who pool the resources of individual investors for passive investment in real estate, whether by direct investment, by financing, by leasing arrangements, or by a combination of such methods. In order to qualify as a REIT, the corporation must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. This is beneficial to investors since it subjects them to only one level of taxation instead of taxation at both the corporate and individual level. REITs were designed to provide investors access to a diversified portfolio of real estate without requiring significant amounts of capital.

Investment Planning Answer Book by Jay L. Shein, Q 2:52, What are the primary benefits of investing in a REIT?

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REITs provide investors access to a diversified portfolio of real estate that would most likely not be possible without significant amounts of wealth. In addition to the potential capital appreciation from which investors may benefit, since the REIT is required to distribute at least 90% of its taxable income, these investments also provide a good investment stream. Investors can easily purchase or sell a REIT immediately without having to deal with the hassles associated with closing on a property, maintaining the property, acting as a landlord, etc.

Investment Planning Answer Book by Jay L. Shein, Q 2:53, What are some other things that should be taken into consideration before investing in a REIT?

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Although REITs do hold multiple properties, an investor should determine first the location and sector of the real estate holdings within the REIT to make sure they are receiving the appropriate diversification. For example, if a REIT invests primarily in commercial property in Atlanta, Georgia, the values of the properties within the REIT will likely be highly correlated and provide less diversification benefits than a REIT that invests in different sectors and across a broader geographic area. Just because a REIT focuses on a specific target area or a specific sector would not rule this out as a viable investment option, but an investor may consider using this with other REIT investments to limit the concentrated exposure.

Although REIT funds avoid the double taxation effect and are only taxed at the individual level, their distributions are not considered as qualified dividends. In 2003, Congress implemented a lower tax rate (equal to 15 percent) on qualified dividends. Since these REIT distributions do not qualify as such, they may be taxed at a higher tax rate. An investor may consider holding these investments in qualified accounts, such as IRAs, since they can continue to defer the tax until withdrawals are made.

Because of the fact that REITs must pay out at least 90 percent of their returns, there is 10 percent or less to invest back into new business. This means that in most cases, REITs grow more slowly than the average stock.

Investment Planning Answer Book by Jay L. Shein, Q 2:54, What is a commodity and how is it exchanged?

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A commodity is simply a physical article or raw material that can be bought or sold. Commodities derive their value based on global supply and demand and are generally considered equivalent in value in spite of the fact that the commodity comes from many sources or producers. Precious metals are one type of commodity. Gold, for example, is a precious metal is mined across the world, yet global supply and demand determines the value for an ounce.

Commodity exchanges are often facilitated through various exchanges. The Chicago Board of Trade and the New York Mercantile Exchange are just two examples of such exchanges. These exchanges allow rapid responses to changes in the global supply and demand and help to provide efficient commodity pricing.

Investment Planning Answer Book by Jay L. Shein, Q 2:55, What are some examples of Commodities?

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- Precious metals
    - Gold, silver, platinum, palladium
- Agricultural
    - Corn, rice, soybeans, wheat, cocoa, coffee, cotton, sugar, oats
- Energy
    - Natural gas, WTI crude oil, brent crude, propane, ethanol
- Industrial metals
    - Copper, tin, zinc, lead, nickel, aluminum, steel
- Livestock and MeatCattle, pork bellies, hogs

Investment Planning Answer Book by Jay L. Shein, Q 2:56, What is a private equity?

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In finance, private equity is an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. Private equities are generally illiquid and thought of as a long-term investment. Private equity investments are not subject to the same high level of government regulation as stock offerings to the general public. Private equity is also far less liquid than publicly traded stock.

Investment Planning Answer Book by Jay L. Shein, Q 2:57, What are some types of private equity?

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1. **Venture Capital.** Venture capital refers to equity investments made, typically in companies in their early stages, to either launch, develop and/or expand a new business. Venture capital investment is often associated with new ideas or products that have not yet been tested. The earlier the investment stage, the greater the risk/return characteristics for the investor. In other words, investing at the very beginning of what may become a profitable technology could offer substantial returns if successful, but the probability of success may not be high. Waiting until a business or idea has begun and just investing in the expansion of that business may provide a lower return, but the investor has a higher probability of success when comparing to the start-up investor.
2. **Leveraged Buyouts (LBO).** At its most basic level, an LBO is a method of acquiring a company with money that is nearly all borrowed. This allows investors to make a large acquisition without committing a lot of capital. The acquirers of the target company often attempt to sell or take the target company public after five or ten years in the hopes of making sizable profits. Doing an LBO can be expensive and complex, but if successful can provide considerable returns. One of the most famous LBOs was the $25 billion takeover of RJR Nabisco by private equity firm Kohlberg Kravis Roberts in 1989.
3. **Distressed or special situations.** This is a broad category referring to investments in equity or debt securities of financially stressed companies. Since this area focuses on investing in entities that are in default, under bankruptcy protection, or headed in that direction, investors must evaluate not only the ability for the entity to make a comeback but also which class of securities might be more beneficial to hold during a restructuring process.
4. **Mezzanine capital.** These are typically structured as either a subordinate debt or preferred stock investment with claims below that of the other debt issued by the entity but above that of the common stock holders. Entities that obtain financing in this manner must pay a higher cost due to the investor's junior position.
5. **Other private equity strategies.** These may include real estate, energy and power, merchant banking, and infrastructure.

Investment Planning Answer Book by Jay L. Shein, Q 2:58, What are American Depository Receipts?

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American Depository Receipts (ADRs) are certificates issued by a U.S. bank and traded in the United States as domestic shares. The certificates represent the number of foreign securities the U.S. bank holds in that security's country of origin. ADRs make trading foreign securities in the United States easier by eliminating currency exchange, legal obstacles, foreign ownership transfers, and the need to trade on a foreign exchange.

Investment Planning Answer Book by Jay L. Shein, Q 2:59, What are master limited partnerships (MLPs)?

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A limited partnership is a partnership in which some of the partners—the limited partners (LPs)—have liability only to the extent of their investment. The LPs do not share in the joint and several liability for the debts of the partnership like the general partners (GPs). In addition, apart from a few exceptions, the limited partners do not have any management authority.

A master limited partnership (MLP) is a publicly traded limited partnership. In order for a firm to be considered as an MLP, a firm must earn at least 90 percent of its income what the IRS considers as "qualifying sources." These qualifying sources may include activities related to commodities, natural resources, or real estate. Some common businesses that choose the MLP structure include natural gas and oil pipeline and storage companies.

Investment Planning Answer Book by Jay L. Shein, Q 2:60, What are some of the advantages of purchasing master limited partnerships (MLPs)?

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Because an MLP is treated as a partnership, or a collection of partners, rather than a separate entity, the partnership passes through all income and does not pay any tax itself. MLPs can avoid the "double taxation" impact that many corporations deal with since the income from the MLPs flows through to the investors via a K-1 that is issued annually. There may be some additional tax benefits to the investor since the partnership distributions are not all taxed at the time of receipt, but rather at the time the MLP is sold. During the investor's holding period, the MLP will make distributions based on the company's distributable cash flow. A portion of that distributable cash flow is considered a return of capital and serves to reduce the investor's basis. *The following example should not be construed as tax advice. The taxation of MLPs may vary and a tax advisor should be consulted for the specific tax implications of each person's investment holdings.*

EXAMPLE 2-7

John purchased MLP units at a cost of $20/unit and holds the units for two years at which time he sells the units for $23/unit. In both year one and year two, the MLP has a distributable cash flow of $1.30 of which $.30 is taxable income and $1.00 is related to depreciation. Since $.30 of the total distributable cash flow is taxable income, the remaining $1.00 of each distribution is a return of capital and thereby reduces John's cost basis by $1.00 each year. At the end of year one, John's adjusted cost basis is now $19 (the original $20 cost basis minus the $1 return of capital). At the end of year two, John's adjusted cost basis is now $18. At the end of year 2 when John sells the investment, he has a gain of $5 ($23 sales price minus $18 adjusted cost basis). Since John has held the investment for more than a year, the $3 appreciation from the original purchase ($23 sales price minus $20 original basis) receives long-term capital gain treatment. The remaining $2 of gain—which in this example was related to the return of capital due to depreciation—is called "recapture" and is taxable as ordinary income.

MLPs can provide considerable tax benefits to an investor during the holding period of the MLP while also producing an attractive cash flow. In addition, the cash flows produced by the MLPs tend to be very stable and produce consistent cash flows on an annual basis. MLPs may also have a lower cost of capital than a taxable corporate entity since they are able to avoid the double taxation and therefore may be able to pursue projects that may not be feasible for a taxable entity.

Investment Planning Answer Book by Jay L. Shein, Q 2:61, What are some of the disadvantages of purchasing a master limited partnership?

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Each year an investor holds an interest in a MLP, they will receive a K-1 detailing their share of the partnership's net income. K-1s may be perceived negatively by investors since the K-1 may add complexity to the filing of their tax returns and could also delay the filing of their return since K-1s are typically issued later than 1099 forms that reflect an investor's dividends and interest on an investment. In addition, the investor may face a sizable tax burden upon the sale of the MLP due to the manner in which the cost basis is reduced over the holding period as described in the prior example.

It should also be noted that if the investor's adjusted cost basis ever declines to $0, any future cash distributions become taxable immediately, rather than being deferred until the sale of the security. This keeps the investment from having a negative basis.

When investors eventually liquidate their MLP position, they will generally be subject to ordinary income tax on the difference between their original basis and the adjusted basis amount. Since this will be taxed at their personal income tax rate, this additional "recaptured" income could propel an individual into a higher tax bracket. While they received the benefit of the tax deferral during the holding period, the investor should be aware of the tax implications upon the sale since this may outweigh the benefits received during the tax deferral period.

From an estate planning perspective, current law provides for a step-up in basis to the value at the date of death for any assets owned at the time of death. Therefore, if an investor holds an MLP at the time of death, they could avoid the negative tax implications described above since they would receive a full step-up in basis to the current date of death market value.

One other drawback of MLPs is the limited pool of investors which reduces the potential demand for MLP units. This is due to the fact that many institutional investors, such as pension funds, are not allowed to hold MLP units without incurring tax liability. A component of the MLP income may be treated as Unrelated Business Taxable Income (UBTI) which could cause some of the MLP's income to be taxable even if held in an otherwise tax-exempt or tax-deferred account, such as a pension or IRA. Investors should be aware of any such UBTI implications when considering this in an IRA or other tax-deferred or tax-exempt type of account.