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# RETIREMENT INVESTING

SPECIALIZING IN INVESTMENT MANAGEMENT AND ASSET PROTECTION

July 2002

## Six Steps for Investing an Inheritance

Over the next 20 years, \$10 trillion will pass from one generation to the next. Most recipients have no idea what to do with the money that they inherit. For many, it is the largest sum they have ever seen, with the possible exception of their retirement savings.

For most, the first inclination is to do nothing. But in many cases, this is a mistake. Here are six steps that you should consider taking, after receiving an inheritance:

### Step One: Research Your Securities

In most of the cases that I have seen, the inheritance comes in the form of a portion of the deceased person's brokerage account. There can be all types of securities in the portfolio from individual stocks and bonds, mutual funds, money market accounts, to just about anything.

For the individual stocks and mutual funds in the portfolio, we can help you find the answers to a handful of questions about each security, including:

- How has this security performed over the past one-, three- and five-year periods?
- Are the returns consistent or erratic? Can you live with that level of volatility?
- For the mutual funds: How expensive are these funds to own? Do they have high expense ratios or back-end loads? Can you choose cheaper alternatives?
- Are these investments sound? For stocks, we can provide you with a report regarding the company's growth, profitability, and financial health. For mutual funds, we can report back to you about how those funds are performing as compared to their mutual fund peer group.

Individual bonds are trickier. Consider the maturity date. The longer the maturity, the more sensitive that bond is to changes in the interest rate. When interest rates rise, the value of the bond on the secondary market goes down. If you have inherited a lot of long-term bonds, you may consider selling some of them if you cannot handle the volatility. You can reinvest that money into shorter-term bonds or in stocks, depending on your target asset allocation.

### Step Two: Identify the Dogs

Maybe you will find that the securities that you have inherited have high category ratings, great stock grades, and consistently exceptional returns. If so, move on to the third step.

But more often than not, you will find some dogs in the portfolio: funds that earn category ratings of 1 or 2, or with unacceptably high fees, or stocks that flunk out in several areas. Flag these securities right away because they should be on your sell list.

There may be some marginal securities in the portfolio, not terrible investments, but not terrific choices either. We can put those on a watch list for the next 12 months and re-evaluate them later.

### Step Three: Identify What Is Not Appropriate

After you have flagged the dogs, think about the types of securities that remain and whether they are appropriate for your individual goals. For example, if you are focusing on growth in your portfolio, Grandma's bonds may not be appropriate. Or, maybe Uncle Joe got crazy with day trading, and you have inherited some very risky technology stocks that you are just not comfortable owning.

In other words, even if you find that you inherited securities that are highly rated, they might not be right for your goals and investment personality. Make a list of those securities that are not a good fit for you.

## Step Four: Determine Your Basis

You have now identified which securities that you want to sell. Next, you have to determine the tax basis in order to calculate your gain and loss position.

Generally, the basis for your securities is determined by the fair market value of the security on the deceased person's date of death. You will need to check the exact date of death, and look up the fair market value of each security at that time. You can find this information in back issues of most newspapers, either in the library or on the Internet. If you can't find what you are looking for in either place, give us a call. We are here to help.

Although most of the time you will use the date of death for this valuation, the executor may elect to value the estate several months after the date of death if the property has not yet been distributed or sold. Ask the executor of the estate what the valuation date is before calculating your tax basis.

Selling securities often means realizing taxable capital gains, but those receiving inheritances do have one perk: They get what is called a step up in basis or value from the deceased person's basis. If you re-evaluate your inheritance within a relatively short period of time after receiving it, such as within a year or two, you may have accumulated a large capital gain. Because inheritances are considered special cases, you may not have to hold the security a year before you are eligible for long-term capital gains rates. As always, consult your tax advisor prior to implementing this, or any other tax strategy.

## Step Five: Reevaluate Your New Portfolio

Take everything that is left from your inherited portfolio and combine it with your own holdings. We can help you find out if your new asset allocation is out of balance, what the inherited securities did to your overall portfolio expense ratio, and whether your portfolio's risk level is higher or lower than it was before.

With a larger overall balance, you will need to recalculate your target positions for each asset class. For example, if your portfolio is now 25% larger, but you inherited no international stocks or mutual funds, you may need to increase your international asset allocation.

## Step Six: Rebalance if Necessary

Take this opportunity to re-examine your asset allocation. Has your life or your goals changed since you originally set that mix? Consider your time horizon, investment goals, and any other personal factors that may have changed.

Reset the overall asset allocation for cash, bonds and stocks. Next, tackle your sub-asset allocation by deciding how much you want in taxable versus tax-exempt bonds, how much you want in large-, mid-, and small-cap stocks, how to split your stocks between growth and value styles, and how much you want in domestic versus foreign securities. Beyond that, identify which mutual funds are core to your portfolio and which are noncore.

If you need to make a lot of changes to your portfolio to get it under control again, consider rebalancing over a period of time, especially if there are capital gains involved.

## Seek Professional Guidance

Not everyone will want to go through each of these six steps. In those cases, we can do it for you. These six steps will walk you through most of what you will need to do.

## Top Ten Portfolio Pitfalls

I have found that there are ten mistakes that many investors make when they try to manage their own portfolio. If we have not consolidated your investment portfolio, looking at the following problems with your investments may help you think about your portfolio as a whole, and not simply as a collection of individual investments. If we have not already done so, I believe that the following Top Ten Portfolio Pitfalls make a strong case for us getting together and conducting a Comprehensive Financial Plan:

1. **Not Defining Objectives and Priorities.** After owning them for a long time, it is easy to forget that the investments in your portfolio are there to do a job. Take the time to think about what that job is, and whether your needs or expectations for that investment have changed. It may be time to sell some of those investments.
2. **Lack Of A Focused Core.** If you find yourself staring at a long list of investments, and you are not really certain why you own them, your portfolio probably lacks focus. For each investment goal that you have identified, you should have a core group of three or four funds that are proven performers. For most growth-oriented investors, large-cap funds will probably make up the core of their portfolios.

3. **Putting Too Much Outside The Core.** Use additional funds for diversification and growth potential. For example, if your core is made up of large-cap funds, you may want to consider adding small-cap, mid-cap, international and sector funds for diversification.

While you probably would not want to put a significant portion of your investment portfolio in any one of these types of funds, they do allow for the possibility of extraordinary returns. However, they also generally carry a higher level of risk. But as long as you limit the more risky portion of your portfolio, you are not likely to significantly threaten the bulk of your investments. And for some investors, core funds may be all they will ever need.

4. **Imbalance.** A well-constructed portfolio is a balanced portfolio. If you see something that stands out, you may need to determine whether it still fits your risk profile. Imbalance happens when some categories do very well or very poorly. If it has not been rebalanced, a portfolio that was balanced three years ago may be out of balance today.

5. **Owning Too Many Funds.** Many investors know that they have this problem, but they just don't know what to do about it. I start by evaluating where each fund fits into your portfolio mix. Is it a core fund or not? It is critical that your core funds be strong performers. If they lag behind their peer group for three years, it is time to make a change. I generally recommend to my clients that they increase the assets in their core funds and take out or sell the poorer performing non-core funds.

6. **Poor Choices Within Categories.** A fund's performance ratings are certainly important, however I believe that a fund's category ratings are more important. Again, compare the fund's risk and return against those of their peer group. If a fund has not kept up with its peer group over the past three years, it is time to think about dropping it.

7. **Inefficient Use Of Tax Strategies.** Is your investment portfolio making the most of tax strategies? Some funds work better in tax-deferred accounts than in taxable accounts. When we conduct a Comprehensive Financial Plan, we work to avoid penalties if you elect to retire early, when to consider a Roth IRA, and other tax-related topics.

8. **Paying Too Much In Fees.** Given two similar funds, I take the one with lower costs. Over time, the difference in the performance between each fund can be dramatic. No matter what anyone tells you, costs do matter.

9. **Excessive Stock Overlap.** I have seen many cases where someone owns a significant amount of their employer's stock in their 401(k) plan, unexercised stock options in their company, and mutual funds that own that same stock. There is nothing wrong with holding some of your employer's stock, but do balance that investment with diversification in the rest of your portfolio.

10. **Not Knowing When To Seek Professional Help.** There are times when it pays to get professional guidance that focuses on your individual situation. Complex tax issues or estate planning can necessitate a trip to a specialist. Just give me a call, or check off the attached coupon, and I will be happy to conduct a free Comprehensive Financial Plan for you.

## ***UPCOMING SEMINARS***

### ***“Unlocking The Secrets To A Successful Retirement”***

**Mrs. Miller's Chicken and Steak House**

4723 Central Avenue, Hot Springs, Arkansas

Tuesday, July 9, 2002 6:00PM

Thursday, July 11, 2002 6:00PM

Tuesday, July 30, 2002 6:00PM

Thursday, August 1, 2002 6:00PM

***Dinner will be served, but seating is limited.***

Call 316-3100 or 800-468-3007 to make your reservation.

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