The Educated Investor
Summer 2000
FOCUS Asset Management Company

Charitable Trusts for Everyone

Summertime provides a wonderful opportunity to plan charitable donations for this and future years' tax planning. As part of your planning, you might wish to take a look at a new breed of charitable trust that recently arrived on the scene — the charitable gift account.

A Low-Cost Alternative to a Private Foundation

When you approach charitable giving as a lifelong strategic endeavor, it can enrich your life immeasurably; through your contributions, you can make a real difference to people in need or institutions that are important to you. But, while you may have decided to give, you may not have made decisions regarding which charities and in what amounts. A charitable gift account can help you achieve your goals. It enables you to take action today to fund a long-term future of giving. It allows you to build a low-cost alternative to a private foundation through a trustworthy organization. In addition, a charitable gift account may offer lower ongoing administrative fees.

Establish a Legacy of Giving

You also can use the charitable gift account to establish a lasting legacy of charitable giving for future generations. You can name the account in honor of your family: "The Jackson Charitable Gift Account" or "The Jackson Fund for the Arts," for example. Grants by the gift account's trustees can be made with an acknowledgment that you recommended the gift, or they can be made anonymously. You can even name a successor to take over your role as donor-advisor or you can recommend that your favorite charities receive the assets of the account outright.

How does the charitable gift account work? Several brokerage houses and various community organizations offer them. Most are similar in operation:

1. You establish a charitable gift account and make a contribution of cash or securities valued at $10,000 or more to the account. Participation does not require you to hire an attorney to create a new trust. You just sign up and give.

2. Contributions are placed in your gift account and are invested in professionally managed investment pools that have the potential to grow tax-free (funding even more charitable giving). You can typically recommend investing your contributions in one or more investment pools, which offer varying levels of risk and potential return.

3. You recommend when grants of $500 or more be made from the account to qualified charitable organizations of your choosing.

Continued on page 4

Several studies have demonstrated that taxes are considered an investor's greatest expense. How does that impact the investment industry? Take this quiz to find out.

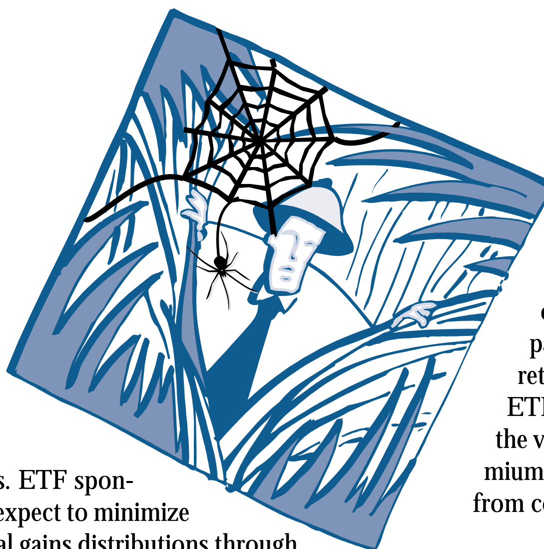
1. In a recent survey, how many investors said the impact of taxes on their stock mutual fund returns is important?
   a. <1 percent
   b. 20 percent
   c. 60 percent
   d. 80 percent

2. Within the 11,000 mutual fund universe, approximately how many funds have a stated "tax managed" objective?
   a. <1 percent
   b. 20 percent
   c. 60 percent
   d. 80 percent

Turn to page 4 for our Investor Tester Instant Answer

What's Inside?

- Spiders, Diamonds and Webs
- Take the Plunge, or Drip by Drip?
- For Your Reading Pleasure
- Worth Repeating



Stalking Spiders and Diamonds and Webs (Oh My!)

Increasing demand for passively managed investment options has also fueled the introduction of a new array of investment vehicles, collectively called Exchange Traded Funds (ETFs). By June 2000, there were nearly four dozen ETFs, with dozens more planned. What are they? What are their advantages and disadvantages? How do they (or do they) fit into your investment portfolio?

Defining the ETF

ETFs resemble a cross between a stock and an index mutual fund. Like traditional index funds, they allow investors to purchase a collection of stocks through a single vehicle, and ETFs can be created to represent virtually any index or asset class. Yet they also share trading features common to stocks and unavailable within funds.

There are many ETF types and providers (you may also hear them referred to as iShares^{sm}, Barclays Global Investors' proprietary name); among the most popular are:

- **SPDRs** — Standard & Poor's Depository Receipts, pronounced "Spiders," track the S&P 500
- **Diamonds** — Track the Dow Jones Industrial Average
- **QQQs** — Pronounced "Qubes," track the NASDAQ 100
- **VIPERs** — Vanguard Index Participation Equity Receipts, are Vanguard's entry into ETFs; they track several of Vanguard's popular indices
- **WEBS** — World Equity Benchmark Securities, track various foreign country indices

ETF Potential Advantages

Tax Efficiency — ETFs are expected to be even more tax efficient than index mutual funds. ETF sponsors expect to minimize capital gains distributions through the trading mechanism that keeps actual trading prices comparable to a fund's underlying net asset value (NAV). Thus it is expected that the only capital gains investors might face are those that occur when they sell their own ETF shares — a decision clearly within each investor's own control.

Reduced Expenses — With their passive nature and operating techniques, ETFs should have operating expense ratios comparable or even lower than those of a low-cost mutual fund.

Greater Flexibility — ETFs offer flexibility by offering trading features associated with stocks (such as continuous pricing throughout the day, the ability to place market and limit orders, and the availability of put and call options). They also are available to foreign, non-US residents who otherwise face tax and regulatory restrictions on purchasing US mutual funds.

ETF Potential Disadvantages

Trading Costs — Similar to trading stocks, brokerage commissions and trading costs (bid/offer spreads) are incurred when trading ETFs. For the buy-and-hold investor, such costs might be acceptable. But of course trading costs can have a significant impact for those investing on a frequent basis or in very small amounts (dollar-cost averaging). Savings on expenses may be offset by trading costs.

Adhering to Passive Asset Class Investing — Most important, proper allocation among all asset classes remains vital to achieve one's investment objectives. For proponents of passive asset class investing, the retail benchmarks upon which ETFs are based do not fully capture the value and small-cap asset class premiums that are expected to be available from certain mutual funds.

Short Track Records — Most ETFs are so new that it is impossible to assess yet whether potential advantages (particularly tax efficiency) are actually being achieved. The exception is the SPDR, which became the first available ETF in 1993, and to date has proven to be an extremely tax-efficient vehicle with respect to capital gains.

Should I Invest in ETFs?

SPDRs have been traded for a sufficient period of time to begin performance analysis; based on our initial analysis, we believe they are a viable investment option for investors who might otherwise be considering an S&P 500 Index mutual fund in a taxable account, and who are not planning to invest frequently or in very small amounts. Beyond this single application, we believe there are better vehicles to use for maintaining a low-cost, tax-efficient, fully diversified portfolio.

Whether or not ETFs prove to deliver on their potential, the educated investor is likely to benefit. First, competition is good; it usually leads to lower costs and product innovations. Given investor demand and the sheer size of the market opportunity facing the investment community, the pace of change is likely to continue at a very rapid rate. Stay tuned … and in touch with your investment advisor.

Take the Plunge, or Drip by Drip?

The good news is you recently received a large lump sum of money. But how do you invest it? Should you "take the plunge," and invest it all at once, or invest gradually, over time?

Because the market has historically risen over time, it seems to make sense to take the plunge. Otherwise you risk making future purchases at increasing prices. On the other hand, perhaps you're afraid that you live under "Murphy's Law," and you might inadvertently buy at the market's highpoint. What if the market falls after you buy? What if you don't buy and the market keeps rising? Facing uncertainties, you might delay your decision indefinitely.

Fortunately, we can offer a solution to the gridlock. The first and most critical step is to write a business plan that outlines regularly scheduled investments. For example:

- ▲ Invest one-third immediately and the remaining thirds in each of the next two months or next two quarters.
- ▲ Invest one-quarter immediately and spread the remainder equally over the next three quarters.
- ▲ Invest one-sixth monthly for six months, or bimonthly for a year.

More important than the specific schedule is *writing down and adhering to it.* But we suggest a maximum of one year to execute your plan; the longer you delay, the more likely you will miss out on market gains.

Once you record your schedule, sign it, and share it with your investment advisor. He or she will help you implement your plan, and will ensure you are not led astray by the latest popular headlines or guru forecasts. Your advisor also can encourage you to adopt the "glass is half full" perspective. If the market rises after an initial investment, you should feel good about your portfolio's performance and about your smart decision to enter the market swiftly. If, on the other hand, the market falls, you can look forward to making future investments at lower prices. Either way you've come out the winner!

Worth Repeating

Worth Repeating

"If you crunch the numbers, [active fund] turnover has to come down, not to low, but to super-low, like 15-20%, or taxes kill you. That's the real dirty secret in our business. Because mutual funds are bought and sold with virtually no attention attached to tax efficiency."

— Theodore R. Aronson, Aronson + Partners
"By the Numbers," *Barrons,* June 15, 1998

For Your Reading Pleasure

Would you like to read more about **charitable gift accounts** (from page 1)? You can visit Charles Schwab & Co.'s Web site on the subject at:

http://www.schwabcharitable.org/

Seeking more information about **exchange traded funds** (from page 2)?

- ▲ The Web is a good source for keeping up with the growing ETF industry. (Although, as with any information on the Web, remember that some sources are more reliable than others!) For example, a June article offered a handy summary of ETFs: "Everything You Want to Know About ETFs — But Didn't Know How to Ask," by Dagen McDowell, Senior Writer at TheStreet.com Network. The link to this article is:

  http://www.thestreet.com/funds/funds/957009.html

- ▲ Burton G. Malkiel, author of *A Random Walk Down Wall Street,* also wrote an interesting article, "Investors Shouldn't Fear 'Spiders.'" The article appeared in the *Wall Street Journal,* May 30, 2000, page A26, and should be easily obtained at your local library — in person, or electronically. (Many libraries today offer magazine back issues on-line to their patrons.)

Charitable Trusts for Everyone (cont.)

Tax Benefits

While there are many ways to structure your charitable giving, there are few alternatives that offer the versatility and tax efficiency of a charitable gift account. Because they are irrevocable, donations to a charitable gift account are generally fully and immediately deductible when the account is established.

The charitable gift account also can reduce your capital gains tax bill. You can donate appreciated securities directly to these funds and realize your donation's full value immediately as a charitable deduction, without incurring capital gains tax liability. If you were to sell appreciated securities and donate the proceeds of the sale to charity, you would be liable for any resulting capital gains tax. (Of course you also can donate appreciated securities directly to a charity if that is more appropriate for your needs.)

Caveats and Considerations

Having described potential advantages of the charitable gift account, please note that situations remain where designing your own charitable trust might be a better solution. Following are some specific items of which to be aware.

- When you establish a charitable gift account, your gift is **irrevocable**! You can typically make recommendations regarding fund pools and gifts, but you no longer own the assets.
- While it is hoped that the professionally managed investment pools in which your gift resides will grow, it is **not** guaranteed. As with many other investments, the value of your gift fund can potentially decrease.
- With a charitable gift account, you cannot retain a lifetime income interest in the asset donated, as you can with a charitable trust.
- Your contributions from within a charitable gift account are *likely* tax deductible, but you might wish to discuss your specific tax status with your tax advisor.

While charitable gift accounts can facilitate "charitable trusts for everyone," seeking the counsel of your investment advisor, CPA and/or attorney is always a good idea when analyzing specific planning opportunities.

Instant Answer
(from page 1)

1. According to the Eaton Vance Management survey appearing in the May 2000 *Practical Accountant*, (d) 80 percent of investors said they considered the impact of taxes on their stock mutual funds to be important. Unfortunately, the study also revealed that approximately one-third surveyed were unfamiliar with the term "tax-efficient investing" and were unable to name any investments offering tax efficiency.

2. Perhaps limited familiarity with tax-wise investing is a result of limited options. According to Morningstar, only (a) <1 percent of all mutual funds have a stated objective of being tax-managed (as of April 2000).

The good news is that funds combining passively managed and tax-managed investing are on the rise, available from sources such as Vanguard, Fidelity and Dimensional Fund Advisors. And recently, Vanguard announced that it would begin reporting mutual fund returns on both a pre- and after-tax basis.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP

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