City State Bank Trusts & Investments
Winter 2018 Newsletter

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COMPANY STOCK AND YOUR PORTFOLIO: KEEP YOUR EYE ON CONCENTRATION RISK

The opportunity to acquire company stock — inside or outside a workplace retirement plan — can be a lucrative employee benefit. But having too much of your retirement plan assets or net worth concentrated in your employer's stock could become a problem if the company or sector hits hard times and the stock price plummets.

Buying shares of any individual stock carries risks specific to that company or industry. A shift in market forces, regulation, technology, competition — even mismanagement, scandals, and other unexpected events — could damage the value of the business. Worst case, the stock price may never recover. Adding to this risk, employees who own shares of company stock depend on the same company for their income and benefits.

TIME FOR A CONCENTRATION CHECKUP?

The possibility of heavy losses from having a large portion of portfolio holdings in one investment, asset class, or market segment is known as concentration risk. With company stock, this risk can build up gradually.

An employee's compensation could include stock options or bonuses paid in company stock. Shares may be offered at a small discount through an employee stock purchase plan, where they are typically purchased through payroll deductions and held in a taxable account. Company stock might also be one of the investment options in the employer's tax-deferred 401(k) plan, and some employers may match contributions with company stock instead of cash.

Investors who build large positions in company stock may not be paying attention to the concentration level in their portfolios, or they could simply be ignoring the risk, possibly because they are overly optimistic about their employer's future. Retirement plan participants might choose familiar company stock over more diversified funds because they believe they know more about their employer than about the other investment options.

WHAT CAN YOU DO TO HELP MANAGE CONCENTRATION RISK?

Look closely at your holdings. What percentage of your total assets does company stock represent? There are no set guidelines, but holding more than 10% to 15% of your assets in company stock could upend your retirement plan and your overall financial picture if the stock suddenly declines in value. If you work for a big company, you may also own shares of diversified mutual funds or exchange-traded funds that hold large positions in your employer's stock or the stock of companies in the same industry.

Formulate a plan for diversifying your assets. This may involve liquidating company shares systematically or possibly right after they become vested. However, it's important to consider the rules, restrictions, and timeframes for liquidating company stock, as well as any possible tax consequences.

An appropriate allocation of company stock will largely depend on your goals, risk tolerance, and time horizon — factors you may want to review with a financial professional. It may also be helpful to seek an impartial assessment of your company's potential as you weigh additional stock purchases and make decisions about keeping or selling shares you already own.

All investments are subject to market fluctuation, risk, and loss of principal. When sold, investments may be worth more or less than their original cost. Diversification is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

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DOES YOUR BUSINESS NEED A BUY-SELL AGREEMENT?

The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. As with most financial decisions, there are expenses associated with the purchase of life insurance. Policies commonly have mortality and expense charges. In addition, if a policy is surrendered prematurely, there may be surrender charges and income tax implications. An individual disability income policy could help replace a percentage of your income (up to the policy limits) if you're unable to work as a result of an illness or injury. The policy will stay in force, regardless of your employment situation, as long as you pay the premiums.

When you're mired deep in the day-to-day challenges of the management of your business, it's often hard to step out of the trees and take a good hard look at the forest. But at various points in the business cycle, it's important to do just that. For example, one of the key decisions you'll need to consider is what would happen to your business if you decide to step away, or you die or become permanently disabled. A buy-sell agreement can be a useful tool in helping you plan for these circumstances.

WHAT IS A BUY-SELL AGREEMENT?

A buy-sell agreement is a legally binding agreement that establishes when, to whom, and at what price you can sell your interest in a business. Buy-sell agreements are also known as business continuation agreements and buyout agreements.

You can create a buy-sell as a separate agreement or you can include certain provisions addressing the buy-sell issues in a business's operating agreement. Regardless, the agreement or provisions must clearly identify the potential buyer, any restrictions and limitations, and the conditions under which a sale will occur. Under the terms of the agreement, you and the buyer enter into a contract for the transfer of your business interest by you (or your estate) at the time of a specified triggering event. Typical triggering events include death, long-term disability, retirement, divorce, personal insolvency or bankruptcy, criminal conviction, loss of professional license, and resignation or termination of employment.

A well-crafted buy-sell agreement creates a market for your business interest, establishes its price, and provides cash to complete the business purchase. The ability to fix the purchase price as the taxable value of your business makes a buy-sell agreement especially useful in estate planning. That's because if death is the triggering event, it can help reduce the estate tax burden on your heirs. Additionally, because funding for a buy-sell agreement is typically arranged when the agreement is executed, you're able to ensure that funds will be available when needed, providing your estate with liquidity that may be needed for expenses and taxes.

PRICING THE COMPANY AND FUNDING A BUY-SELL AGREEMENT

A buy-sell should establish a formula for determining the purchase price or state the price outright. Without establishing this price in advance, lengthy disputes and lawsuits can arise at the time the ownership interest must be bought back. When the buy-sell involves family members, it must also be proven that the transaction is comparable to an arms-length sale between unrelated people and was entered into for a bona fide business purpose. After determining the value of the business, you, your advisors, and other parties to the agreement will determine the best way to fund the transaction and the triggers appropriate for your business situation. There are many different ways to fund a buy-sell agreement, including a sinking fund, cash, borrowed funds, installment sale, self-canceling installment note, private annuity, life insurance, and disability insurance. Depending on the situation, one or more of the possible methods may be used.

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TYPES OF STRUCTURES

Buy-sell agreements can be structured to meet the needs of both the business and its owner(s), taking into consideration tax consequences and individual goals.

Continued on next page.

LIFE IS FOR THE LIVING, AND SO IS LIFE INSURANCE

Life can be busy. The requirements of work and family often leave little time to step back and think about where you've been and where you're heading. But as your responsibilities grow, so does the need to evaluate what would happen if life for you stopped. Now is a good time to reflect on how life insurance can help those you leave behind — the living.

YOUR SPOUSE OR LIFE PARTNER - A successful marriage is often predicated on sharing and providing for one another, and that includes each other's financial obligations. If you were suddenly no longer in the picture, would there be enough money to pay for your final expenses, cover debt, and buy some time to allow your significant other to adjust to a new way of life? Life insurance can provide funds to cover immediate expenses and income to help support your surviving loved one.

YOUR CHILDREN - You've worked hard to provide for your kids, to give them the chance to realize their hopes and dreams. Your children are likely your greatest responsibility — a responsibility that doesn't end with your passing. Whether your children are in diapers or about to enter college, if something happened to you or your spouse, or both of you, would there be enough income to continue to provide financially for your children? Life insurance can help provide the resources for their continued growth and maturation.

YOUR HOME - Buying a home may be the largest single expenditure of your life. While being a homeowner is exciting, mortgage payments, often lasting 30 years, along with maintenance, utility costs, homeowners insurance, and real estate taxes can add up to a long-term financial commitment. Adequate life insurance protection can provide funds that could be used to cover these expenses, allowing your family to remain in their home.

YOUR BUSINESS - Do you own your own business? Life insurance can fit into your business plan in many ways. It can be part of an employee benefit program, with coverage under a group plan. Life insurance purchased on the lives of certain key employees can protect your company from the loss of talented and valuable workers. And life insurance can be used to fund a buy-sell agreement.

CARING FOR AN AGING PARENT OR LOVED ONE - Are you caring for an aging parent or loved one? Would the people who depend on you be able to afford quality health care and a comfortable place to live without your financial support? Life insurance can become extremely important in these situations, helping to provide for these individuals in the event of your death.

PLANNING FOR RETIREMENT - Preparing for retirement probably means you're saving as much as you can in your 401(k), IRA, or other savings vehicle. If you die before you get to enjoy your retirement, will your retirement plan die for your surviving loved ones as well? Not only will your salary be unavailable to help pay for current living expenses, but your income won't be there to build the nest egg for the retirement of your spouse or life partner. Life insurance can help provide funds that can be used for your spouse's or life partner's retirement.

YOUR HEALTH HAS CHANGED - If your health declines, how will it affect your life insurance? A common worry is that your insurer could cancel your coverage should your health change. However, changes to your health will not affect your current insurance coverage, provided you continue to pay your premiums on time. In fact, you should take a closer look at your life insurance policy to find out if it offers any accelerated (living) benefits that you can access in the event of a serious or long-term illness.

LEAVING A LEGACY - Life insurance can be used to increase the size of an estate for your heirs. The death benefit could provide your beneficiaries with a larger legacy than might otherwise be possible. The cost of life insurance may be significantly less than the proceeds of the policy paid to your beneficiaries when you die.

CHARITABLE GIVING - Donating a life insurance policy to a charity may enable you to make a larger gift than you otherwise could afford. Further, the government encourages charitable giving by providing tax advantages for certain charitable donations (the charity must be a qualified charity). This means that both you and the charity could benefit from your donation (though some charities may not accept a gift of life insurance for various reasons).

DOES YOUR BUSINESS NEED A BUY-SELL AGREEMENT? (CONT.)

Following are three types of buy-sell agreements, along with brief descriptions of each:

- An entity purchase (or redemption) buy-sell obligates the business to buy the interests of the departing owner(s).
- With a cross-purchase buy-sell, each owner agrees to buy a share of the departing owner's interest. The business is not a party to the transaction.
- A wait-and-see buy-sell is used when the parties are unsure whether the business or the owners will buy the business interest. Typically, the business is given the first option, and if it is not exercised, the remaining owners are given the opportunity. If the remaining owners do not wish to buy, the business must purchase the interest.

OTHER CONSIDERATIONS

Keep in mind that there are costs and possible disadvantages involved in establishing a buy-sell agreement. One such disadvantage is that the agreement typically limits your freedom to sell the business to outside parties. If you think that a buy-sell agreement might benefit you and your business, consult your attorney, accountant, and financial professional.

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HOW DO TIPS HELP FIGHT INFLATION?

One way to help protect your portfolio against a sudden spike in inflation is by investing in Treasury Inflation-Protected Securities (TIPS).

TIPS are guaranteed by the federal government as to the timely payment of principal and interest. They are sold in $100 increments and available in maturities of 5, 10, and 30 years. The principal is automatically adjusted twice a year to match any increases or decreases in the Consumer Price Index (CPI). If the CPI moves up or down, the Treasury recalculates your principal.

A fixed rate of interest is paid twice a year based on the current principal, so the amount of interest may also fluctuate. Thus, you are trading the certainty of knowing exactly how much interest you'll receive for the assurance that your investment will maintain its purchasing power over time.

TIPS pay lower interest rates than equivalent Treasury securities that don't adjust for inflation. The difference between the yield of nominal bonds and inflation-linked bonds with similar maturities is called the breakeven inflation rate. It is the cost for inflation protection and a market-based measure of expected inflation.

If you hold TIPS to maturity, you will receive the greater of the inflation-adjusted principal or the amount of your original investment; this provides the benefit of keeping up with inflation while protecting against deflation. Considering that there has been some inflation every year over the past 60 years, the principal of TIPS held to maturity is likely to be higher than when they were purchased.[1]

The return and principal value of TIPS on the secondary market fluctuate with market conditions. If not held to maturity, TIPS may be worth more or less than their original value. They are also sensitive to movements in interest rates. When interest rates rise, the value of existing TIPS will typically fall. Because headline CPI includes food and energy prices, TIPS can also be affected by volatile oil prices.

Unless you own TIPS in a tax-deferred account, you must pay federal income tax each year on the interest income plus any increase in principal, even though you won't receive that money until they mature.

[1] *U.S. Bureau of Labor Statistics, 2017 (data through December 2016)*

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IMPORTANT DISCLOSURES

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