# Helping clients reach wise inheritance decisions

The first key: seek mutual agreement on three fundamental principles

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Many of our clients understand that an inheritance is going to come their way but nevertheless are unprepared for it when that day arrives.

We see a variety of inheritance cases ranging from large and complex, to more moderate and straightforward. Regardless of size and complexity, we impress upon our clients that it can be a deceptively complicated exercise to integrate inherited assets into their existing investment portfolio.

When clients request advice on inherited financial assets, our starting point is to seek mutual agreement on three fundamental principles.

The first is that the bequeathed financial assets may have suited the benefactor's financial goals but aren't necessarily right for the inheritors. Mom and Dad or Uncle John may have been savvy investors, but they built a portfolio to meet their own financial goals rather than the goals of the inheritors.

## Keep an open mind

From this standpoint, we encourage clients who receive financial assets to keep an open mind as to what to keep and what to liquidate.

The second principle is that sentiment can be a legitimate decision criterion in those instances where clients have an especially strong emotional connection to their inheritance, as long as risks are discussed and understood. We strive to help our clients find the proper balance between the pragmatic and emotional aspects that arise from receiving an inheritance.

A recent case in point was a client who received a relatively large block of telecommunications company stock originally owned by her parents. Within the family lore, this stock was considered a major wealth builder, though it hadn't served this function for decades. In memory of her parents, the client wished to retain the stock.

We encouraged her to consider three questions, as we would any client when sentiment and practical considerations appear to be at odds:

• Will the asset add risk to the investment portfolio incommensurate with its potential return?

• Could the magnitude of a potentially negative return from this asset severely harm the client's ability to reach her goals?

• Will the client be comfortable if the asset delivers mediocre results over time?

The third and most critical principle is that evaluating inherited financial assets should be as disciplined a process as possible. For first-time inheritors, this concept isn't always as self-evident as one might assume.

## Inconsistent criteria

People often use inconsistent criteria and an irregular process when evaluating inherited financial assets.

We caution clients that without a comprehensive approach and a predetermined set of decision metrics, it is easy to lose sight of the whole picture. Decisions that may appear reasonable in isolation can prove counterproductive when viewed in relation to the client's entire financial situation.

To help clients address this process, we seek to break it down into four steps:

**Cash flow needs.** We encourage clients to assess their immediate and near-term cash needs. Recently, for example, a client decided to use inherited assets for a major home remodel, rather than eliminate a high-interest-bearing debt. In this case, we took time to make sure that the client understood the trade-offs so that he and his wife could make a well-informed decision.

Once clients decide how they intend to deploy inherited cash, we review all sources. Outside money market funds and cash accounts are one thing, but we caution clients that liquidating mutual funds, exchange-traded funds, annuities, real estate investment trusts, and individual stocks and bonds shouldn't be done without sufficient consideration. Before taking any steps, all applicable information should be assessed to guard against unfavorable outcomes that might result from taxes and withdrawal penalties.

**Asset allocation.** Most clients recognize that adding inherited investments to their portfolio indiscriminately can throw their asset mix out of balance. We seek to focus their attention on the most cost-effective ways to integrate bequeathed financial assets without compromising a portfolio's risk/return balance.

It isn't unusual for clients to wish to replace funds in their existing portfolios with inherited funds that appear to be similar but have superior track records. We understand the rationale behind this but often have to point out that seemingly comparable funds can have meaningfully different risk levels and market behaviors, and aren't necessarily interchangeable.

In recent years, gold has become a popular investment, and it isn't unreasonable to think that clients could inherit gold-related assets. In those instances, it is important to explain that other holdings such as commodities funds often have precious-metal exposure and that keeping the gold-related investment could exceed the appropriate strategic allocation for this asset.

**Individual investments.** We always forewarn clients that more inherited assets are likely to be discarded than retained. The majority of mutual funds, ETFs, variable annuities and other pooled-investment vehicles fall prey to our quality review, oftentimes based on excessive fees and expense ratios, mediocre investment performance and tax inefficiency. Similarly, we analyze each individual stock and bond holding. Because stocks in particular lend themselves to subjective judgments, it is important to present our analysis to the clients in order to gain acceptance and agreement with our recommendations.

If the client inherited annuities, we check if harsh surrender charges are imposed should the client wish to sell them. Surrender provisions are often written in language that can be difficult to understand. Provisions also can differ widely among annuities sponsored by the same insurance carrier.

**Taxes.** A large portion of inheritances today arrive within individual retirement accounts, Roth IRAs and other tax-deferred plans, including 401(k)s. It is vital for financial advisers to know the inheritance-related rules governing these vehicles.

Similarly, it is essential for clients to be educated on tax-deferred plans and tax rules when liquidating investments. Clients are often surprised when they are shown the amount of money they may forgo if they don't take into account tax regulations. However, we counsel clients not to allow a tax overhang to keep them from making advantageous investment decisions. There has to be a prudent balance.

Due largely to demographics, the number of clients in our practice receiving inheritances appears to be growing. To augment our personal work with them, we have created a white paper that focuses on many of the issues they need to address.

Above all, it emphasizes that integrating inherited assets into an existing portfolio requires a disciplined approach that should pay heed to reassessment of goals, risk tolerance, asset allocation and tax implications. With proper guidance, advisers can help inheritors make better choices that can provide meaningful benefits for them and their families.

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