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THE INVESTMENT COUNSELOR

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MARKET OUTLOOK

By Ralph E. Weil, CFA

With the end of the second quarter behind us, we have seen a remarkable snap back in the equity markets both here and abroad, peaking in early June. With an eye to previous bear markets, this is a typical

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The Power of the People

HOW SHAREHOLDER VOTES ARE RESHAPING CORPORATE BOARDROOMS

By Kathleen M. Habegger, CFP®

Corporate governance can be defined as the set of processes, customs, policies, laws and institutions affecting the way a corporation is controlled. Key elements of good corporate governance principles include honesty, trust and integrity. The officers of publicly traded corporations and their board of directors have a responsibility to the company's shareholders to operate their corporations in an ethical manner.

The collapse of Enron and Worldcom in 2001 brought corporate governance into the spotlight. As these two examples revealed, stock options and bonuses linked to short-term share price performance could lead to aggressive and even fraudulent earnings manipulation to achieve target share prices, thus enabling management to qualify for generous remuneration packages. Performance incentives could create a climate where employees sought to generate increased profits at the expense of the company's stated standards of ethics and strategic goals. In a July 2002 poll[1], 73 per cent of respondents said that Chief Executive Officers of large corporations could not be trusted. In an effort to restore public confidence in corporate governance, the U.S. government passed the Sarbanes-Oxley Act in 2002.

Sarbanes-Oxley imposed a number of new checks and balances on public corporations. Among other requirements, public corporations were forced to make prompt disclosure of any material changes in their financial condition or operations, and an accounting oversight board was established to enforce compliance with professional accounting standards. Perhaps most significantly, the Chief Executive Officer and Chief Financial Officer of public corporations were required to certify that the company's financial statements accurately and fairly represented the financial condition and operations of the company. Intentional false certifications would result in criminal prosecution.

With such stringent accounting oversight regulations now in place, one would imagine that shareholders would start to feel more confident in the integrity of corporate officers and boards. Indeed, soon after the new legislation took effect, investors regained confidence in stocks and share prices rebounded. For the next few years, shareholder proposals on annual proxy ballots tended to focus on social and environmental issues, and corporate boards were routinely re-elected.

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MESSAGE FROM THE PRESIDENT

By Peter J. Boyle, CFA, CIC

Regulatory Change

Throughout history, generational attitudes have been forged through common life events which have defined, or re-defined, fundamental beliefs. Most notably for our industry are individuals who are products of the Great Depression, but indelible marks are also made by major wars and domestic conflict.

When speaking of my generation, I have often made the observation that we have been influenced not by turmoil, but the lack thereof, enjoying decades of relatively uninterrupted prosperity. I would contend that this uninterrupted prosperity contributed to an "it will never end" attitude which, in turn, provided fuel for overblown housing prices, low saving rates and exotic investments structured with overly optimistic scenarios in mind. Clearly the door to this period of overconfidence has been slammed shut and, as with defining moments in past eras, current events will likely foster societal impacts for future generations to ponder.

Regulators and politicians, however, are not waiting to ponder and have moved quickly—perhaps too quickly—to make changes meant to prevent potential future abuses in our financial system. Already, as Carolyn Barber points out in this newsletter's Q&A section, the SEC will begin asking advisor clients directly to confirm their assets and are using their rule-making ability to embed additional protections. One proposed rule will make it onerous in the future to simply deduct advisory fees from brokerage/custodial accounts, an option most of our clients currently utilize.

Washington is also hard at work considering alterations to the decades-old Investment Advisers Act of 1940—the legal basis for our industry. Unfortunately, as often seems the case in Washington, a power struggle has ensued between those with vested interests in the outcome. Of particular importance to our clients and all consumers of investment services is the proposed concept of "harmonization." Simply put, the Investors Advisers Act established the fiduciary standard of care for investment advisors which contrasts with the lesser suitability requirement applied to brokers found in other legislation. Some rule-makers now argue that investors appear to be confused by these differing "standards of care" and are calling for "harmonizing" them into a single standard. We adamantly maintain (as we have since our founding) that consumers are provided the best protection by objective, unbiased advice based on a fiduciary standard of care. Effective enforcement of the existing rules, and not wholesale alterations, ought to be the focus. Stay tuned.

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Smooth Sailing

Much to the chagrin of her fellow partners and clients, Katie Habegger will be retiring after a 20 year association with Clifford Swan. In 1989, Katie was drawn to this industry—and more importantly to our firm—by Phil Swan's articulation of his singularly focused goal: to make a positive difference in the lives of his clients.

Small firms rely heavily on every member for their success and growth, and Katie has been a constant contributor to our firm's accomplishments. During her tenure, Katie achieved her Certified Financial Planner designation, managed the firm's technology and portfolio administration functions, served as both the fixed income and equity trader and most recently acted as the firm's Chief Compliance Officer. In each case, she diligently stepped into whatever role was needed. Most notably, she did so while living up to Phil's challenge to positively impact the lives of her significant group of clients with a sensible and sensitive determination we will all miss.

Among Katie's accomplishments is her recognition outside the firm, including the 2003 honor by Pasadena-based Women at Work as one of their Outstanding Working Women Award recipients.

What's next for Katie? A long time sailor (competitively as well), she and her husband Phil are headed for the open seas aboard their sailboat, Avalon, and more relaxed time with grandchildren.

We all thank Katie for her years of dedication both to her clients and her partners and wish her smooth sailing. ◆

IRS UPDATES

Mortality Assumptions

By *Kenneth H. Dike*, Esq., CPA

The mortality assumptions used by the IRS to calculate charitable deductions for gift annuities and additions to split-interest trusts have been updated and are now based on the 2000CM mortality table effective for gifts made after April, 2009. Special transitional rules allow for a two-month "grace period" during which either the prior or revised mortality assumptions may be used for the charitable deduction.

The charitable deduction for gifts to charitable remainder trusts, charitable lead trusts, pooled income funds, and charitable gift annuities involves a present value calculation. When the duration of these arrangements is based on the remaining life of a beneficiary, the present value calculation includes an estimate of the beneficiary's life expectancy. The IRS, through its regulations and related tables, specifies the method, discount rate, and life expectancy estimate to use for these present value charitable deduction calculations.

A mortality table reflects the number of deaths in a population by age. Life expectancy tables are constructed from this mortality data giving an estimate of the remaining life at each age. For the past ten years, the IRS life expectancy estimates were based on the 90CM mortality table created from the 1990 U.S. Census data. Since the IRS is required to update their mortality assumptions at least every ten years, they have recently published revised present value tables incorporating the data from the 2000CM mortality table created from the 2000 U.S. Census.

The change in life expectancy from the 90CM mortality table to the 2000CM mortality table is slight as shown by the following table:

	Life Expectancy (years)		Change
Age	**90CM**	**2000CM**	**% of 90CM**
0 (birth)	75.37	76.83	1.9%
20	56.63	57.79	2.0
40	37.98	38.87	2.3
60	20.90	21.54	3.1
80	8.40	8.42	0.2

Accordingly, this life expectancy estimate update produces only a small change in the resulting charitable deduction calculation holding all other variables constant. Below is a chart showing the charitable deductions for a $10,000 gift with a 5% payout and a 2.8% discount rate for a charitable gift annuity and charitable remainder unitrust at various life beneficiary ages:

	Deduction		Change
	90CM	**2000CM**	**% of 90CM**
Life Beneficiary Age 60:			
Gift Annuity	$ 2,484	$ 2,287	-7.9%
Unitrust	3,960	3,822	-3.5
Life Beneficiary Age 70:			
Gift Annuity	4,516	4,399	-2.6
Unitrust	5,337	5,244	-1.7
Life Beneficiary Age 80:			
Gift Annuity	6,430	6,418	-0.2
Unitrust	6,797	6,786	-0.2

The charitable deduction for gifts to charitable remainder trusts, charitable lead trusts, pooled income funds, and charitable gift annuities made after June, 2009 must be based on the 2000CM mortality table. Charitable deductions for gifts made during the months of May and June (2009) can be based on either the 90CM or 2000CM mortality table if the IRS discount rate for May or June is also used for the calculation (IRS permits the use of the discount rate for the month of the gift or the prior two months). If the IRS discount rate for April is used for a May or June gift, the charitable deduction must be based on the 90CM mortality table. Charitable deductions for gifts made prior to May, 2009 must be based on the 90CM mortality table.

Calculating these types of charitable deductions is something we do for our clients at Clifford Swan Investment Counsel. You can rest assured that we will use the appropriate parameters when doing these calculations in order to achieve the highest charitable deduction allowed given your unique situation. ◆

A Family Goal

By Linda Davis Taylor

Especially now, families are concerned not only with preserving their financial wealth, but with maintaining and enhancing their overall social health and capacity for stewardship by successive generations. As we all come to terms with the reality that financial assets can be less reliable than we thought, family leaders are saying to themselves, "we may not be as financially secure as we had hoped and planned." And with no guaranteed silver bullets for economic recovery, what can families do to prepare the next generation for the future?

The Challenge of Successful Wealth Transition

Jay Hughes, noted estate planning attorney in the field of family wealth, often recalls the old Chinese proverb, "shirtsleeves to shirtsleeves in three generations." This proverb predicts that the wealth that was created by the first generation is likely to disappear by the end of the third generation.

The unfortunate truth of this saying is underscored by research in a recent study of 3200 families by the Williams Group, citing that wealth transition failed in 70% of these families. Interestingly, this failure was attributed to investment management in only 3% of the cases with the remainder due to other factors within the family's ability to control, or at least influence. How can families avoid this result?

One approach lies in the wisdom of Gary S. Becker, University of Chicago's Nobel Prize winning economist who argued, *"People cannot be separated from their knowledge, skills, health, or values in the way they can be separated from their financial and physical assets."* Dr. Becker's work on human capital theory provides the framework for defining a family's wealth in a much broader way by thinking not only about financial capital as wealth but also the human, intellectual, and social capital as equally, if not more important, for long term family success.

How do human, intellectual, and social capital relate to family wealth?

First, let's look more closely at some definitions offered by family wealth visionary Lisa Gray:

Human capital:
Unique talents, happiness, well-being, health, ethics and morals of each member of the family.

Intellectual capital:
Heritage, traditions, faith, life experiences, education, and skills of family members.

Social capital:
Responsibility, service, charitable activities.

Financial capital:
Stocks, bonds, cash, real estate, family business, "things."

Most of us would probably acknowledge the importance of human, intellectual and social capital for a "successful life," but we have traditionally considered our wealth in terms of financial capital alone. The broader view of "family wealth" suggests that by thinking of our financial capital as a tool to grow the other forms of capital—human, intellectual, and social—we can sustain family success across generations by recognizing and investing in each family member's ability to thrive individually which in turn re-energizes the family as a whole. Think about the collective "assets" of your family as all the talents, knowledge, skills, and unique experiences each family member brings to your family's culture.

An example of how this works in a family is when parents or grandparents pay for the education of a child or grandchild, who, with the right training and experience, later joins the family business, thereby using the financial capital that the family provided to increase her intellectual capital, ultimately contributing to the family's well being. The child who directs his or her interest in "giving back" to working with a not-for-profit organization, or who develops his or her artistic talent is equally valuable to building the family by adding to it a whole different dimension of knowledge.

How can families incorporate this approach in managing their wealth?

Families can adopt a broader approach to managing their family wealth through incorporating activities designed to build the human, intellectual, and social capital alongside their management of the financial capital. A family's mission and vision should reflect their shared values, because families that are linked by a commitment to elements of a common purpose or philosophy have a greater likelihood of long term success beyond three generations. Identifying and agreeing on this common purpose and then involving family mem-

Think about the collective "assets" of your family as all the talents, knowledge, skills, and unique experiences each family member brings to your family's culture.

Just as a plan for managing financial capital should not be left to chance, the same is true for managing the other crucial aspects of family wealth.

bers through education and joint activities such as philanthropy can be as important as thoughtful estate planning and investment management in sustaining the family over multiple generations. Family members benefit from understanding "why" family wealth exists as well as "how" it is invested.

Governance–Planning–Investment

The Importance of a Plan for Family Governance

Just as a plan for managing financial capital should not be left to chance, the same is true for managing the other crucial aspects of family wealth. Sound family governance includes a careful approach to defining the family's core values, forming the basis of its mission and overarching purpose. Educational activities designed for the next generation or other family members not well versed in financial matters builds their capacity for stewardship and individual financial independence. Involving the family in charitable activities exposes them to philanthropy, instilling a sense of responsibility for giving back to the community.

Family Wealth: The human, intellectual, social and financial capital of a family.

Human Capital: The individual members of the family and their collective talents, values and well-being.

Family Governance: A dynamic process of activities performed to preserve the family's wealth - human, intellectual and financial.

Intellectual Capital: The unique heritage, traditions, experiences, educations and skills of each family member.

Education: Providing family members with the knowledge and skills to maximize their individual success and as stewards of family wealth.

Social Capital: Responsibility, service and impact on society.

Philanthropy: The charitable interests and activities of the family.

Financial Capital: Resources to support the growth of human, social and intellectual capital.

What can a family do to begin its "sustainability plan?"

The summer season brings more opportunity for family gatherings, whether a large scale "family reunion" or a simple picnic or trip to the beach. Even a short family holiday provides opportunities for conversations about some aspect of the family history, values, or involvement in the community. Some simple topics can be used to create a sense of connection to the family history, such as describing some colorful family members from the past and what characteristics made them so. Or, involve the younger generation by asking them, "What cause most interests you?"

Families that establish a culture of pride across all generations in their legacy and appreciation for the characteristics and accomplishments of their family members that are not always financial will surely have a better chance of avoiding the "shirtsleeves to shirtsleeves" fate. ◆

Linda Davis Taylor is the Chairman of the Board of Clifford Swan Investment Counsel and Managing Director of CCM Family Advisors. CCM Family Advisors assists families in achieving success across generations by fostering family cultures that sustain legacy and protect wealth.

SAFETY OF
Custodial Assets

By Kenneth H. Dike, Esq., CPA

In light of the recent problems encountered in the financial services industry, some of our clients have expressed concern over the safety of their assets.

The short answer is that Clifford Swan Investment Counsel does not "hold" the assets we invest. Our clients' assets are held, in custody, at brokerage firms and banks such as Charles Schwab & Company and City National Bank. As assets held in custody, federal law requires that they be segregated from the custodian's corporate assets and are not subject to the claims of the custodian's creditors. Accordingly, the safety of our clients' assets does not depend on the financial health of Clifford Swan or the custodian.

The American Bankers Association has addressed this issue in a December 2008 memorandum and made it clear that the safety of custodial assets "is not dependent upon whether the bank has assets greater than its liabilities" and the assets held in custody accounts "belong to the owner(s) of the accounts and would be unaffected by a bank failure." Regarding custodial assets, this memorandum provides that:

Non-cash custodial assets "do not become assets or liabilities of the bank and are segregated from the bank's assets. The bank's role as custodian is to hold the assets for safekeeping, to collect dividends and interest and provide other similar services. Account ownership in the assets, other than cash, remains vested in the individuals or entities for whose benefit the bank is acting as custodian and the assets are not subject to the claims of creditors. Cash in custody accounts that is held in non-interest bearing transaction accounts may be fully insured by the FDIC. Cash held in the trustee bank in other types of deposit accounts is insured up to $250,000."

Although banks and brokerage firms are regulated by different government agencies and subject to different regulations, both are required to segregate custodial assets from their own corporate assets. The financial health of the custodian in both situations does not affect the safety or value of the custodial assets they hold.

This "custodial risk" must be differentiated from "investment risk". Securities in a custody account will increase or decrease in value depending on the financial health of the company issuing the security and not the financial health of the company holding the security as custodian. For instance, a security issued by Bank A and held, in custody, by Bank B will decline in value if Bank A has financial difficulties but NOT if the custodial Bank B has financial difficulties.

Managing the "investment risk" is what we do at Clifford Swan. The "custodial risk" is mitigated primarily by the laws covering the banking, brokerage, and custody activities, and secondarily by the internal controls of the custodian itself. Furthermore, this "custodial risk" is insured at various levels including mandatory coverage by the FDIC (Federal Deposit Insurance Corporation) and SPIC (Securities Protection Investors Corp), and often supplemental coverage through other sources such as Lloyd's of London. ◆

MARKET OUTLOOK

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pattern after a major market bottom. While the recovery in stock prices has been wide spread, the largest moves have been in companies that have survived after trading like they were going to go out of business. So where are we now and what do we see in the immediate future?

The market has run up about 35% since the bottom reached in early March which is a very big move in a very short period of time. Just the sheer size of this advance would suggest that the market should pause and rest at current levels. In relation to earnings, book values, cash flows, and dividend yields, stocks generally seem to be fairly valued, further arguing against any strong upward price movement in equities in the near future.

The greatest unknown factor affecting the future direction of the market is the economy and the timing of the recovery. Curiously, this uncertainty has led to a whole litany of letters and symbols used by economists and the media to describe potential recovery paths. Variations on "V", "W", "U", and "square root" provide visual representations of the relative slopes for downturns and bounce-backs, as well as any plateaus in between. For example, the square-root recovery implies that following a sharper downturn and bounce back (reminiscent of a V), the economy will muddle along for some time. While the wide variety of descriptive scenarios underscores the economic uncertainty ahead, we have long held that when the economy does turn, the recovery will be slow and shallow for a period of time. This variation of a "U" recovery path has been described as a "saucer" recovery.

While we are encouraged by recent positive signals (where three months ago there were none), for each step forward, the economy is still taking two back. In some cases, these "positive" signals really represent negative signs that have become less negative. For example, the

downward spiral of housing statistics has become less steep, and some parts of the country are reporting positive data in a few categories. Likewise, the rate of change in new claims for unemployment insurance has lessened. Though it may sound to a pessimist like we are grasping at straws, we believe that the worst is behind us. While there is a chance that the economy could head back down again, the combined effects of the stimulus package and the actions taken by the Federal Reserve render the likelihood of a second bounce down less probable with the passing of time. Indeed, we see this optimism reflected in consumer confidence which has rebounded from its bottom.

We have stated in the past that the economy should turn from negative growth to positive growth in the second half of 2009, most likely in the fourth quarter. This remains our forecast. With a slow economic (saucer) recovery, we will continue to monitor for signs that inflation pressures are building, but we do not believe rising prices are imminent.

During this recession companies have become much leaner in their operation which bodes well for both cash flows and earnings in the expected slow recovery. In normal recoveries we expect to see both good revenue growth and margin expansion. In this recovery, revenue growth will be slow, but we anticipate positive margin expansion along with cash flow and earnings growth. While we are not predicting the usual summer rally this year due to the major run-up in the equity indices we have seen since March, neither are we looking for a major pull back in equity prices at this time. Rather, we expect a trading range of 10% either way over the balance of the summer. We will take this time to adjust portfolios to reflect the areas and companies we feel offer better value and represent opportunities for growth on a longer horizon of two to five years. ◆

QUESTION & ANSWER

SEC PLANS TO

Contact Clients

By Carolyn S. Barber, CFA, CIPM

The U.S. Securities and Exchange Commission (SEC) is charged with oversight of all Registered Investment Advisors. The core mission of the SEC is investor protection. Recent events have exposed weaknesses in the SEC's oversight effort. Bernie Madoff's confession that he ran an enormous Ponzi scheme for nearly twenty years was particularly embarrassing to the SEC. SEC examiners visited Mr. Madoff's firm numerous times over the years, but found only minor deficiencies. The SEC also failed to follow up on persistent reports from a credible whistle-blower, who could have exposed the scheme.

Mr. Madoff did not use an independent custodian to hold his clients' assets. As a result, his clients did not have statements issued from a separate entity to compare with the statements they received from Mr. Madoff. Most Registered Investment Advisors, including Clifford Swan, use a bank of brokerage firm to serve as custodian and to issue account statements directly to clients (please see related article on page 6 of this newsletter). This protects our clients because they can compare the statements from their custodian to the statements we send them and thereby confirm their account balances and activity.

In reaction to the agency's blatant failure in the Madoff case, the SEC has begun a new procedure as part of its examination of investment advisors. The SEC has decided to directly contact advisors' clients with a "Routine Account Information Confirmation." This is a form asking the client to confirm account balances and recent additions and withdrawals.

What does it mean if I receive a letter from the SEC asking for confirmation of an account balance?

It means that the SEC is conducting an examination of your advisor's books and records. The request to clients for independent confirmation of assets is a new procedure, and may be a part of a routine examination. It does **not** mean that the SEC suspects or has found any problems at the advisor's firm.

What should I do if I receive a request for account confirmation from the SEC?

You may decide to voluntarily provide the information requested by the SEC, or you may decide not to respond. Whether or not to provide the information is entirely up to you. If you decide to respond, we recommend that you first confirm that the letter is actually from the SEC by calling their Examination Hotline at 202-551-EXAM.

How can I find out more about this new SEC procedure?

We would be happy to discuss the new procedure with you. If you want to see the SEC's cover letter and new form, we will mail you a copy. Or you can see them on the SEC's website at: http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf ◆

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THE POWER OF THE PEOPLE *continued from page 1*

Fast forward to the stock market collapse of 2008, and the investors' mood changed radically. Once again, we witnessed the collapse of large corporations such as Lehman Brothers, Bear Stearns and Merrill Lynch as the sub-prime mortgage meltdown caused a cascade of business failures. Investor confidence was badly shaken.

As proxy season rolled around earlier this year, it became obvious that shareholders were looking to apportion blame for the loss of their equity. An increasing number of shareholder proposals sought to impose a "say on pay" – shareholder approval for executive benefits packages. (It should be noted that companies receiving TARP/TELF funds are required to include a "say on pay" measure on their ballots as a condition of accepting Government funds). Although, in the past, shareholders have routinely approved executive pay proposals, Royal Dutch Shell shareholders voted in May against executive compensation packages, protesting that the bonuses had not been earned since the company had missed its performance goals.

Perhaps the most significant illustration of shareholder dissatisfaction is the recent grass roots effort to restructure corporate boards. In April, a successful shareholder resolution forced Bank of America CEO Ken Lewis to resign as Chairman, the first ever binding by-law resolution to pass at an S&P 500 company. More recently, three board members of Pulte Homes, running unopposed for re-election, failed to receive a majority of votes at the annual shareholder meeting and were required to submit letters of resignation.

Even when shareholder proposals are defeated, the momentum for change can build over time. A good example of this is the trend towards the annual election of all board members. For many years, companies have maintained "classified" boards, whereby only a portion of the board was subject to election in any given year. This had the advantage of retaining an experienced team of directors, but shareholders argued that it made boards less accountable to their shareholders. As a result of shareholder pressure through "declassification" proposals over the years, staggered boards are gradually being phased out and the majority of S&P 500 companies now have declassified boards, subject to re-election each year.

Clifford Swan Investment Counsel is responsible for voting proxies for hundreds of thousands of our clients' shares each year, and we take this responsibility very seriously. Proxies and shareholder materials are delivered to us electronically, and we then match the number of ballots to our clients' holdings to ensure all eligible votes are cast.

Our internal Proxy Committee has established voting guidelines which are regularly reviewed to ensure they remain current and relevant. In general we:

- Support proposals that give shareholders more power to change the board, such as the annual election of directors, proposals to declassify the board and proposals to allow cumulative voting for directors.
- Vote in favor of proposals that increase board members' independence. We believe that the majority of board members should be non-management related.
- Oppose anti-takeover proposals requiring supermajority voting and so-called "poison pill" provisions.

However, each ballot requires careful consideration, and we use the independent research of proxy advisors Egan Jones to assist us in analyzing proxy proposals. In addition, we give careful consideration to shareholder proposals relating to socially responsible issues (such as global labor standards and environmental impact) through an in-house review.

It can be readily seen that shareholders wield a great deal of power through the proxy process, and corporate boards have been forced to pay attention. We continue to believe that good corporate governance results in enhanced shareholder returns over the long term: a win/win for both management and shareholders. ◆

1. Conference Board, 2003.