

Market Index	July Change	Year-to-Date
Standard & Poor's 500	7.6%	11.0%
Dow Jones Industrial Average	8.7%	6.6%
Russell 2000 (small company)	9.6%	12.5%
MSCI EAFE (international)	9.1%	17.9%
Barclays Intermediate Gov/Credit Index	1.4%	3.0%
3 Month Treasury Bill	0.0%	0.1%
Commodities	3.0%	17.9%

Continuing recovery

The recovery in the economy and world equity markets continued in July, with equity markets extending their rally. The S&P 500 recorded its third best July on record and stands nearly 50% above its March low. Corporate bonds outperformed low-yielding, risk-free Treasury bonds as investors across asset classes became less risk averse and more hopeful.

The Materials and Consumer Discretionary sectors were the top two performing equity sectors as cyclical stocks continued to benefit from growing economic evidence that we are nearing the end of the recession. The 2nd quarter GDP report showed a decline of 1.0%, a much slower pace than the 1st quarter's 6.4% decline. Housing data released in the month also suggests that conditions are at least stabilizing: the S&P Case-Shiller home price index rose for the first time in three years, housing starts grew more than expected, and home sales showed a nice seasonal improvement.

While the economy is recovering, to date it has done so by declining at a slower rate-not a recipe for a sustained market advance. Unemployment is still likely to remain an issue in the coming year, but that is not unusual. In most market recoveries, unemployment continues to rise in the year following a market upturn.

Better than expected earnings...but still sharply down

In July, earnings season was in full swing, with 70% of the S&P 500 companies reporting quarterly earnings for June. Seventy-two percent of companies reporting met or exceeded consensus estimates. A common theme was the tremendous amount of expense reduction, reflecting not only corporations' flexibility to react to weak demand, but an expectation that business growth will likely remain subdued for quite some time. While earnings are expected to decline 22% in 2009, estimate revision trends have begun to stabilize and the consensus 2010 earnings growth currently suggests a lofty 25% earnings growth forecast. In fact, only one year after one of the worst recessions in our history, four sectors are forecasted to post all-time record profits next year.

Gridlock is good for investors

The U.S. dollar fell in July, partly due to an investor appetite for commodities and riskier currencies, but also as an indicator of worry about high levels of government debt. Part of July's equity rally might be explained by declining public sentiment and Congressional delay on government reform initiatives, such as cap-and-trade legislation and universal healthcare reform, increasing the likelihood that these plans will be watered down.

Grantor Retained Annuity Trusts...A Timely Wealth Transfer Tactic

With low interest rates and a stock market that remains well off its peak, the economy today provides a unique opportunity to pass substantial wealth to family via a **Grantor Retained Annuity Trust ("GRAT")**.

GRATs are particularly appealing for those who continue to be concerned with estate taxes (generally, those owning assets greater than \$3,500,000 for an individual, or \$7,000,000 for a married couple) and are looking for ways to transfer assets to family without paying gift or estate taxes.

A typical GRAT is an irrevocable trust that makes fixed annual distributions to the grantor (usually a parent) for a term of years, after which the trust assets are distributed to the grantor's children. By establishing a GRAT, the grantor divides the ownership of the assets into a current interest of annual distributions, which they retain for themselves, and a future remainder interest, which the grantor gifts to children.

The gift to children may be subject to gift taxes. But, if the grantor is living at the end of the GRAT term, the assets remaining in the GRAT that pass to children will not be taxed in the grantor's estate.

The taxable gift to the children is calculated as follows:

$$\text{Taxable Gift} = \text{Trust Assets} - \text{Present Value of Annual Distributions to Grantor}$$

Note that a GRAT can be structured so that the present value of the distributions to the grantor are equal to the value of the GRAT assets, resulting in a zero taxable gift. These trusts are often called "Zeroed-out" GRATs.

The present value of the annual distributions to the grantor is calculated using an IRS discount rate that varies monthly and is based on mid-term interest rates. For August, the IRS discount rate is 3.4%, reduced from 4.2% a year ago, and 6.2% in August, 2007.

Essentially, the discount rate is the rate of return the IRS assumes the taxpayer will earn on the GRAT assets. However, if the GRAT assets appreciate at a rate of return greater than the IRS discount rate, the remaining assets will pass to the children free of gift or estate taxes (if the grantor survives the GRAT term).

And, when the IRS discount rate is historically low, and decent stock returns are expected, the spread between the IRS' discount rate and actual returns can be substantial, resulting in significantly greater tax-free transfers to children from the GRAT than when interest rates and stock values are higher.

For example, if a grantor transfers \$1,000,000 to a 3-year GRAT which makes annual distributions to the grantor of \$356,000, the 3.4% IRS discount rate will result in a zero taxable gift. However, if the GRAT averages annual investment return of 8%, \$103,000 will be distributed tax-free to children at the end of the GRAT term. If the GRAT averages a 10% annual return, \$152,000 will pass to the children tax-free.

Zeroed-out GRATs can be very appealing for people who have already used their lifetime gift tax exclusion (\$1,000,000 per person), but are interested in making additional tax-free gifts to family.

Also, in difficult markets where the grantor may not be feeling as financially secure, GRATs are appealing because the trust will return the original assets to the grantor, plus the IRS discount rate, which may alleviate concerns with giving substantial assets away to family.

To consider whether a GRAT could be helpful to your situation, please call your portfolio manager or Michael D. Barnes for more information.

Michael D. Barnes is President of Johnson Trust Company, a subsidiary of Johnson Investment Counsel, Inc., Cincinnati's largest independent wealth management firm with over \$4 billion under management. Michael is also President of the Johnson Charitable Gift Fund, a public charity providing donor advised accounts and endowment funds. He is an attorney with over 20 years experience assisting clients in preserving wealth through wise estate and charitable gift planning.



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