

SECTION 1: FINANCIAL PROFILE OF A CLIENT TO DEVELOP INVESTMENT STRATEGY

1a. TYPE OF CLIENT

Before going into the specifics of developing the customer's financial profile, the basics about each type of client must be known.

There are 3 broad categories of clients:

Personal Customers;

Institutional Customers; and

Fiduciary Customers.

Personal customers are:

Individual Account

Individual account: An account where a single person wishes to open an account for his or her benefit. To open an account for an individual, no special paperwork is needed.

Individual Account Held TOD

Transfer On Death

Pay On Death

Individual account held "TOD" or "POD": A problem with an individual account is that when the owner dies, the account gets "locked-up" until it goes through the deceased individual's estate and it must go through probate, where anyone can contest the will. Most states now allow an individual account to be held "TOD" - Transfer on Death, also called Pay on Death ("POD"). TOD registration allows the customer to maintain control over the account, but upon death, the account assets transfer to the named beneficiary, bypassing the estate and bypassing probate. No one can contest the transfer.

TOD registration is often used by an elderly parent that wishes to have assets pass directly to an adult child upon the elderly owner's death, and is often used in second marriages where there are children from the first marriage and each spouse wants to make sure that his or her assets go only to his or her respective children upon death.

Totten Trust

TOD Account At A Bank

Also note for the exam that banks have a similar type of account to "TOD" registration called a "Totten trust." This is not really a trust account, since any adult can open one without a trust document. These are usually small bank accounts where a beneficiary is named to receive the account balance at the depositor's death. Often, the

beneficiary does not even know of the existence of the account. The depositor can revoke the "Totten trust" at any time without penalty.

Joint Account

Joint Account: An account where more than one person, say a husband and wife, wish to open an account, for their mutual benefit. To open such an account, a signed joint account agreement is needed, signed by each named person on the account.

Two options are available for joint account ownership:

Joint Tenancy With Rights Of Survivorship

Joint Tenancy (with Rights of Survivorship): Each party owns an "undivided interest" in the account. If one party dies, the other person is the sole owner of the account. This ownership option is most common for husband and wife. Another name for this type of account is "Tenants by Entirety" and it can also be referred to simply as a "Joint" account.

Tenancy In Common

Tenancy in Common: Each party specifies a percentage interest in the account. If a person dies, his percentage interest is included in his estate. It can then be passed by will to any named person. This ownership option is most common for business partners.

Family Limited Partnership Account

Family limited partnership account: Limited partnerships are business forms that allow for "flow-through" of gain and loss to the partners - without the business itself being taxable. The family members are the partners in the venture. These are used for estate tax planning purposes where typically the parents are the general partners who contribute assets to a trust over which they maintain control.

The heirs (children) are the limited partners, who have no management role - they are the passive investors. The parents use their "estate tax credit" so that no estate tax is due when the assets are contributed to the trust; and the value of such assets contributed to the trust is "discounted" since these assets are worth a lesser amount when they are held via a limited partnership (partnership assets are "illiquid"). So the parents might contribute a \$700,000 house to the trust; but it goes into the trust at a \$600,000 value against the estate tax credit. This discount is one tax benefit; the next benefit is that each parent then "gifts" \$14,000 worth of his or her shares each year to each child (up to \$14,000 of gifts can be given in 2014 to a recipient without the donor having to pay gift tax - note that this amount is adjusted for inflation annually). Thus, over time, the asset in the trust becomes the property of the children without an estate tax bill.

To open such an account, a copy of the certificate of limited partnership (the document filed with the State to create the legal partnership entity) must be obtained.

Institutional customers are:

**Sole Proprietorship
Account**

Sole proprietorship account: A sole proprietorship is a business owned by 1 individual. To establish such a business does not require any filing in the State; the person simply starts business operations. This is typical for small businesses, since no formal State charter is required. Sole proprietorships do not pay corporate income tax; but all earnings are subject to personal income tax. Sole proprietors have unlimited liability for all business debts, which makes this form of operation not too attractive. No special paperwork is needed for this type of account.

**General Partnership
Account**

General partnership account: A general partnership is formed when two or more persons form a business enterprise under the terms of a general partnership agreement. The agreement is filed with the State and names each general partner and their percentage share of income and loss in the venture. The partnership itself is not taxable - each partner's share of income and loss is included on that partner's personal tax return. Thus, there is no "double taxation" that is inherent in "C Corporations" (covered following). However, each general partner bears unlimited liability for all business debts, making this form of operation unattractive. A copy of the partnership agreement filed with the State is needed to open this type of account.

**Limited Partnership
Account**

Limited partnership account: A limited partnership is formed when 2 or more persons form a business enterprise where at least 1 person is a general partner and 1 person is a limited partner (there must be at least 1 of each). The general partner is the manager of the venture and bears unlimited liability. The limited partner(s) is (are) the passive investors, whose loss is limited to their investment in the partnership. The partnership itself is not taxable - each partner's share of income and loss is included on that partner's personal tax return. Thus, there is no "double taxation" that is inherent in "C Corporations" (covered following). Because these allow "direct participation" in income and loss, these are commonly referred to as "DPPs" - Direct Participation Programs. A copy of the certificate of limited partnership filed with the State is needed to open such an account.

**DPP - Direct
Participation Program**

C Corporation Account

C Corporation account: A C corporation is a type of company that, under the IRS code, is a taxable entity. The corporation computes net income (or net loss) and must pay corporate income tax on any net income. If the corporation pays a cash dividend to shareholders out of "after-tax" income, the shareholders must include the dividend amount on their personal tax returns, and pay personal income tax on the distribution. Thus, C corporation cash dividends are said to be "double taxed." Though the tax status of C corporations is less beneficial, in return shareholders have limited liability - the most that they can lose is their investment.

To form a C Corporation, a certificate of incorporation must be filed in the State. Under the terms of that state's corporate charter, the corporation is bound to the laws of that State. A copy of the corporate charter is needed to open such an account.

S Corporation Account

S Corporation account: A corporation that has 100 shareholders or less can elect "S" corporation status for tax purposes. S corporations are not taxable entities - all items of income and loss flow-through onto the shareholders' personal tax returns (similar to partnership taxation). Thus, smaller companies and family owned companies, can take advantage of limited liability and avoid the "double taxation" inherent in C Corporations. A copy of the corporate charter is needed to open such an account.

Limited Liability Corporation Account

Limited liability corporation account: A relatively new type of business form "LLCs" are neither a corporation nor a partnership. They are formed as business entities that give the "flow through benefit" associated with S Corporations (or partnerships) without the shareholder limitation imposed on S corporations (maximum of 100 shareholders). In addition, LLC "members" (the owners are neither shareholders nor partners) can take a management role without being considered to be general partners in a venture (who would assume unlimited liability). Thus LLCs have the benefits of flow-through taxation and limited liability. To form an LLC, a certificate of organization must be filed in the State. A copy of this document is needed to open an LLC account.

The following table compares the major types of business ownership forms:

	Sole Prop.	General Part.	Limited Part.	C Corp.	S Corp.	Lim. Liab. Corp.
Number of Owners	1	Unlim.	Unlim.	Unlim.	100	Unlim.
Liability of Owners	Unlim.	Unlim.	Limited	Limited	Limited	Limited
Life Of Business	Unlim.	Limited	Limited	Unlim.	Unlim.	Either
Entity Subject Fed Income Tax?	No	No	No	Yes	No	No If So Set Up
Needed Documentation	None	Part. Agree.	Part. Agree.	Articles of Incorp.	Articles of Incorp.	Articles of Org.

Fiduciary customers are:

Trust Account

Trust account: In a trust, a trustee is appointed to manage the assets for a beneficiary under the terms set forth in the Trust Agreement. The terminology associated with trusts is "legalistic," but must be known for the exam:

Settlor

Settlor (also called Grantor or Trustor): The settlor is the individual who establishes the trust, donates the assets to the trust, sets the objectives of the trust, names the beneficiary(ies) of the trust and names the trustee.

Trustee

Trustee: A fiduciary that manages the assets of the trust in the best interests of the beneficiary(ies).

Beneficiary

Beneficiary(ies): The individuals named in the trust document for whom the assets are being managed. The trust document may, or may not, bequeath the assets to the beneficiary(ies) on the death of the settlor.

Legal List

The trust is a legal entity formed in the State, with the trustee being a fiduciary over the account. Fiduciaries are often limited by each State in the types of investments that can be made. State law requires that fiduciaries either follow the "prudent man" rule or restrict investments to a "legal list" provided by the State.

Prudent Man Rule

Under the prudent man rule, only investments that would be made by a prudent individual are

permitted. If the State restricts investments to its legal list, then only the securities on the list are available for investment. Generally, legal list investments consist of debt rated in the top 4 ratings categories (BBB or better). A copy of the trust agreement must be obtained to open the account. The agreement will specify the types of transactions that the trustee is allowed to perform.

Inter-Vivos Trust

Trusts can be set up during one's lifetime (called an "inter-vivos" trust - which is Latin for "during one's life" or can be established in one's will upon death (called a "testamentary" trust - as in "last will and testament"). Inter-vivos trusts can be set up either as revocable or non-revocable trusts, whereas testamentary trusts are non-revocable.

Testamentary Trust

**Revocable Trust
Taxation**

In a revocable trust, the grantor retains control over the property by reserving the right to revoke the trust. The view of the IRS is that since the individual grantor retains control, the income in the trust is the same as income to that individual, taxed at personal income tax rates to that individual. On the other hand, income in a non-revocable trust is taxed at "trust" rates to the trust itself (a separate trust tax return is filed).

**Non-Revocable Trust
Taxation**

Estate Account

Estate account: The goal of the executor of an estate account is to perform an orderly distribution of estate assets to beneficiaries after paying all liabilities of the estate. During the time period that this takes (which can be years), the executor must strive to earn a reasonable return on the estate's assets. The paperwork needed to open such an account is a certified copy of the death certificate; copy of the last will and testament; and inheritance tax waivers.

1b. PERSONAL CUSTOMERS

**Individuals;
Joint Accounts;
Family Limited
Partnerships**

The relationship between an investment adviser and client begins with the adviser gathering data about the client to construct a portfolio that meet's the client's objectives. For personal clients - individuals; joint accounts; and family limited partnerships; the information that must be gathered includes:

Current financial status of the client;
Family composition;
Tax situation;
Employment information

Once this basic information is gathered, then the next information to be collected is more subjective, including:

Financial goals;
Investment objectives;
Investment knowledge;
Investment time horizon;
Risk tolerance.

Let's examine each one of the items listed above for individual customers in more detail

**Current Financial
Status**

Current financial status of customer: A listing of the customer's assets and liabilities must be obtained. These include:

Assets

Cash and marketable securities

Not readily marketable investments (such as limited partnership investments, business investments, and investment real estate)

Investments Held in Retirement Plans

Market Value of Artwork, Furnishings and Other Personal Tangible Assets

Market Value of Automobile(s)

Market Value of Personal Residence(s)

Liabilities

Credit card payables

Household bills payable

Personal notes payable

Secured loans (where marketable securities, tangible assets, automobile or real estate is pledged as collateral)

In addition, the customer's current and anticipated levels of income and expenses must be examined.

First, the customer's income must cover all anticipated expenses, plus leave a reserve for unexpected expenses;

Second, the market value of assets pledged as collateral for secured loans must at least equal (but preferably exceed by a comfortable margin) the value of the loan;

Third, the market value of cash and marketable securities must comfortably exceed all unsecured payables.

Given that these 3 parameters are met, the net excess of cash and marketable securities over all unsecured payables is the amount of funds that can be invested in a portfolio (less a cash reserve).

Family Composition

Family Composition of Client: To determine the type of investment strategy that will be employed, consideration must be given to the client's family obligations. Items to be considered include:

Does the client have young children, for whom future college payments must be provided?

Does the client have any dependents that need medical assistance that is not covered by insurance?

Does the client have elderly dependent relatives, for whom living assistance must be provided?

Tax Situation

Tax Situation: If the client is in a low tax bracket, then taxable investments may be appropriate. However, if the customer is in a high federal tax bracket, a tax-sheltered investment may be suitable; or a municipal bond investment may be appropriate.

Tax Filing Status

Choosing the right tax filing status is also important to minimize tax liability for customers. There are 5 possible filing statuses - 3 if the person is unmarried and 2 if the person is married. These are:

Single:

Head of Household;

Qualifying Widow(er) with Dependent Child(ren);

Married Filing Jointly;

Married Filing Separately.

Marital status is based on whether that person was married as of the last day of the tax year.

**If Unmarried, Then
Head Of Household
Or Qualifying
Widow(er) Status
Will Lower Tax Bill**

As a general rule, for single individuals, choosing either Head of Household or Qualifying Widow(er) with Dependent Child(ren) status will result in a lower tax bill (there is a larger standard deduction and lower tax rates - the government is helping out single parents here). To choose

either of these, the individual must have a dependent child and must pay for at least 1/2 of household expenses. In addition, for qualifying widow(er) status, that person's spouse must have died within the past 2 years.

**Married Filing
Jointly Gives Lower
Tax Bill If 1 Works**

If a couple is married and only 1 works; or if 1 has a very high income and 1 has a very low income; then choosing "Married - Filing Jointly" status typically results in a lower tax bill. This is the case because the higher income gets "averaged down" when it is added to the lower income, where the joint amount is taxed at a lower joint tax bracket.

**Married Filing
Separately Gives
Lower Tax Bill If
Both Are High
Earners And There
Are Large Itemized
Deductions**

However, if a couple is married, both are high earners, and 1 or both have large itemized deductions, then choosing "Married - Filing Separately" status usually results in lower taxes. This occurs because there are "add-backs" that reduce itemized deductions based on reported adjusted gross income, and this "add-back" number is lower when income is split and reported separately.

Marriage Penalty

When a couple gets married, they may encounter a rather unpleasant aspect of the tax code known as the "marriage penalty." Because tax rates are progressive, 2 individuals that marry may find that when they report their joint income, it is taxed at a higher rate (because tax rates are progressive) and the amount of tax paid is more than the total of the 2 separate amounts paid previously. The tax code attempts to deal with this by increasing the marital exemption amount, but it doesn't always work. The "marriage penalty" tends to hit couples that earn similar amounts; it is not as much of an issue where 1 spouse earns considerably more than the other.

**Employment
Information**

Employment Information: How long has the customer been employed by the same firm? How is the job going? How is the firm doing? Does the customer expect to remain in this job for a long time or for a shorter time frame?

If the customer has been in the same job for an extended period of time; and if the firm is doing well; then the customer can reasonably expect to remain in that position. Thus, reserves of cash needed for a period of unemployment can be reduced. On the other hand, if the customer's job situation is more tenuous, then extra reserves of cash may be necessary.

If the customer's income is fairly static, and is not expected to change over time, then this calls for a less speculative investment program. On the other hand, if the customer's income is expected to grow, given that the customer is still many years from retirement, then a more speculative investment program may be appropriate.

Financial Goals

Financial Goals: The customer is asked what his or her financial goals are. The problem with the response is that it is often much too general. For example, a response of : "My goal is to make money" doesn't tell you very much. Common goals are:

To fund college education for children;

To fund retirement or early retirement;

To fund for the care of aging dependents;

To pay off a primary residence mortgage early;

To fund for major lifestyle purchases such as a vacation home; boat; or expensive car.

However, more information is needed about the goal in order to select appropriate investments.

To fund college education for children - How many children does the customer have? What are their ages (how many years until they will go to college)? Do they have any assets currently, such as custodian accounts, which can be used in the future to pay tuition? Are they likely to go to public college or private college? How quickly are college tuitions rising? Are they likely to go on to graduate school? Are they likely to get scholarships? Are they likely to live at home or away? Will they work while in school? All of these questions are necessary to determine how much money will be needed; and by when; to meet this goal.

To fund retirement or early retirement - How many years will it be till the customer will retire? If the customer is married, will the spouse be retiring at the same time. What amount of pension benefit will be received at retirement? What type of lifestyle does the customer wish to support in retirement?

To fund for the care of aging dependents - Does the customer need to pay for support currently, or how many years in the future is it anticipated that this will occur? How long is the time frame during which it is anticipated that support will be provided? Will there be any insurance to help pay for the support? Does the dependent have any income or assets that can be used towards the support?

To pay off the mortgage on a primary residence early - In how many years does the customer wish to pay off the mortgage? Does the customer wish to pay

off the mortgage in stages or in one lump sum? Will there be any other conflicting needs that require large payments of cash due at the same time that the mortgage will be repaid?

To fund for a major lifestyle purchase such as the purchase of a vacation home - In how many years does the customer wish to purchase the home? Does the customer wish to pay in full or in part? How will the carrying expenses of the home affect the customer's overall expenses? Will the home be rented out to generate income to cover carrying costs when the customer is not using it?

Capital Needs

A more formal name for the determination of a customer's financial goals is a "capital needs analysis." This term is most often used when determining the amount of life insurance that a person should purchase based on the "capital needs" of the surviving family members, but is also used in financial planning. So funding college education for children is a capital need at a fixed date in the future; funding retirement is a capital need at a fixed date in the future, etc.

As you can see, there are a lot of questions that need to be asked about any specific goal that a customer has in order to determine the appropriate investment strategy to meet that goal.

Investment Strategy

Investment Strategy: In each of the goals listed previously, to meet that goal, a certain amount of money must be available at a future date. For example to fund a child's private 4 year college education, for a child that is currently 8 years old, we know that, in today's dollars, about \$30,000 per year must be paid out 10, 11, 12, and 13 years from now. It is relatively easy to determine how much annual investment is necessary over the next 10 years to fund these payments. However, what is not so easy to determine is:

Risk Tolerance

What is the risk tolerance level of the customer? If the customer is willing to assume a higher level of risk during funding, then smaller annual payments into higher yielding common stocks might be appropriate; if the customer is not willing to assume risk at all during fund, then higher annual payments into lower yielding Treasury securities might be appropriate.

Also, when assessing risk tolerance, does the customer have a tolerance to assume extra risk for potentially higher returns (with the extra variability of return that comes as part of the package)? Is the customer's level of risk tolerance

limited to accepting potentially higher or lower returns for assuming extra risk; but the customer will not accept the possibility of negative returns for assuming extra risk?

Current Cash Flow

Is the customer willing to reduce current levels of spending during funding? Typically, customers have a goal that is "out of reach" unless either current spending is cut or the "cost" of the goal is reduced. Will the customer limit his or her current lifestyle to free up the necessary funds to meet the goal?

Current Investments And Strategies

Are the customer's current investments (if any) deployed in vehicles that are suitable to meet the customer's financial goals? Are there any costs associated with liquidating these investments and redeploying them in more suitable vehicles? What are the tax consequences of liquidating these investments and redeploying them in more suitable vehicles?

Time Horizon

Will the customer allow a reasonable time horizon to achieve the goal? It is not uncommon for a customer who has 5 years to retirement; and nothing saved; to decide at that point that it is time to begin investing for the "big date," 5 years of funding is not a sufficient time horizon to generate the returns needed to provide for retirement. The customer must be made aware of the amount of time needed to reasonably achieve the goal; and must be committed to provide the needed funding in each of those years to achieve the goal (even if this means cutting current spending).

Investment Knowledge

Does the customer understand the features, benefits and risks of the proposed investments to be made? It is common to question the client about his or her experience with different kinds of investments. When doing this, the client should indicate his or her:

familiarity with the investment type;

prior use of the investment type;

satisfaction level with the investment type.

Again, a deeper understanding of a customer's knowledge must be obtained than just asking about the information listed above. If a customer says that he or she is familiar with common stocks; that does not mean that the customer knows enough about them to make informed investment decisions.

Because a customer is unfamiliar with a type of investment, say a mortgage-backed pass through certificate, does not mean that it is not appropriate for the customer.

Other considerations in determining the appropriate investment strategy are mainly non-financial. These are:

- Customer Demographics** Demographics of the customer: Is the customer young, middle age, or older? Is the customer low income, middle income, or high income? Is the customer educated or not educated?
- Customer Values** Values of the customer: Is the customer a "spender" or a "saver"? Is the customer willing to sacrifice current consumption for future benefit? Does the customer wish to provide an inheritance for family members or does the customer wish to "live it up" in retirement? Does the customer wish to make significant donations to charities?
- Insurance Approach** Insurance approach: If the customer dies prior to meeting the investment goals, will his or her beneficiaries be able to live comfortably?
- Life Insurance Owned By An Irrevocable Trust Or By Another Person Is Excluded From Decedent's Gross Estate** Consideration should be given to buying enough life insurance to cover the funding of the plan, if the customer should die prematurely. Also note that life insurance proceeds are excluded from the deceased's gross estate if the insurance is held by an irrevocable trust or is held by another person (e.g., a wife owns the insurance policy of her husband) and are not subject to estate tax - so the amount of coverage to be purchased simply has to equal (not exceed) the unfunded amount.
- On the other hand, if the insurance policy is owned by the decedent, then it **would be** included in the decedent's gross estate - so it is critical to make sure that the insurance policy is owned by someone **other** than the decedent!).
- Capital Needs Analysis** A "capital needs analysis" is performed to determine the amount of insurance that should be purchased. It is based on the cash needs upon the insured's death - how much will the funeral cost, how much money is needed to meet the needs of the dependents, how much money is needed to pay estate taxes, etc. From this amount is deducted the amount of existing assets available to pay these expenses, including existing insurance coverage. This calculation is unique to each individual. There is no "standardized computer program" to do this, but

each insurance company typically has its own "capital needs" calculator on its website for potential clients to use.

1c. INSTITUTIONAL CUSTOMERS

Institutional customer (corporations and partnerships) have different needs and goals than personal customers.

For businesses such as sole proprietorships, general partnerships, limited partnerships and corporations, typically asset management means managing current assets to provide a reasonable return on investment; without tying up those assets in investments that are hard to liquidate if the enterprise's cash needs so dictate.

First, the available assets for investment must be determined.

In a business, current assets are cash, marketable securities, accounts receivable and inventory.

Current liabilities are accounts payable, wages payable, taxes payable and notes payable - all due within 1 year.

The excess of "cash assets" (cash and marketable securities) over current liabilities is the "liquid net worth" of the company.

Thus the amount that is available for investment (less a cash reserve).

The time horizon for investing these funds must be closely examined. Will the company need access to these monies for future planned expansion? Does the company need to fund upcoming pension liabilities with part or all of the funds?

Another factor is expected investment return. A company might be better off using the funds to buy back its own stock (if the company is generating a higher rate of return) than investing these funds in a portfolio of other issuer's securities.

Tax situation is another factor for companies. C corporations that invest in the equities of other companies can take advantage of the corporate dividend exclusion - 70% of dividends received are excluded from taxation. This can make equity investments by C corporations more