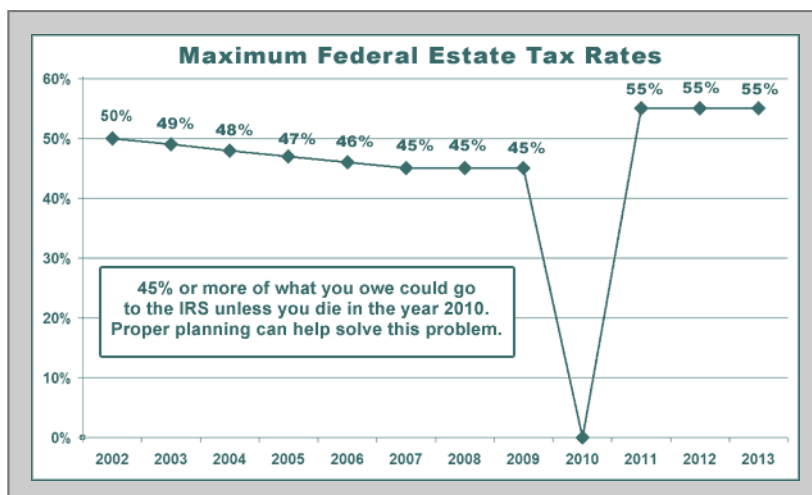




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Grantor Retained Annuity Trusts (GRATs)

Grantor retained annuity trusts (GRATs) have become an attractive estate planning tool for wealth transfer because of the current, low interest rate environment.

A GRAT is an irrevocable trust useful in transferring wealth and making lifetime gifts. The grantor makes a gift of property in trust while retaining an annual income stream (annuity) for a specific period of time. The value of the assets transferred to the GRAT is frozen at the time of transfer for gift and annuity payment calculations. At the end of the GRAT term, all assets remaining in the trust, including appreciation, transfer tax free to the beneficiaries of the trust.

The success of a GRAT is dependent on three main factors. The first is the appreciation of the assets within the trust during the GRAT's term. This dictates that the best assets for funding a GRAT are those with the expectation of high appreciation and/or high current income yield. Annual annuity payments can be made with cash from the earnings, sales of GRAT assets, or can be made in-kind, with the assets of the trust. GRAT payments can be structured to require lower payments in the earlier years of the trust, thus affording additional time for appreciation in the underlying assets.

The second main determinant of a GRAT's success is the Section 7520 rate (in reference to the code section of the Internal Revenue Code) which is set monthly by the federal government. This is frequently referred to as the "hurdle rate" as this is the return the assets must exceed during the GRAT term to accomplish the goal of transferring wealth free of gift tax. With a low 7520 rate at inception of the trust, it is more likely that the growth on the underlying assets of the GRAT will exceed the rate. All income and appreciation, in excess of that required to pay the annuity, accumulates for the benefit of the remainder beneficiaries and transfers free of additional estate or gift tax at the end of the GRAT term. The current 7520

rate available for August transfers is 4.8%.

The final factor for a successful GRAT is that the grantor must survive the trust term. If the grantor dies prior to the end of the trust, the entire value of the GRAT assets can be included in his/her taxable estate as if the trust had never been created. It is important to select the term of the trust with care so that the grantor is likely to live beyond the termination of the trust and distribution of the property to the beneficiaries.

A GRAT is an irrevocable trust useful in transferring wealth and making lifetime gifts.

Depending on how a GRAT is structured, the grantor will pay minimal or no gift tax. When a GRAT is structured to pay out the original value of the assets contributed, this is referred to as a "zeroed-out GRAT," and there is no gift tax at the time of transfer. This practice has been validated by the Tax Court in a case brought by Audrey Walton, an heir to Wal-Mart founder Sam Walton. The IRS acknowledged and accepted the Tax Court's ruling in November 2003, and now this type of structure is known as a "Walton GRAT".

The time to evaluate the benefit of this technique is now because as interest rates rise, the marginal benefit of the GRAT decreases. Ask these basic questions: Do I own assets with high appreciation potential? Do I have a taxable estate and would like to gift assets now with little or no gift tax consequence? If the answers are "yes", a GRAT may make sense for you. Contact us and we will help you explore this and other estate planning and wealth transfer options. ■

Financial Markets Perspective

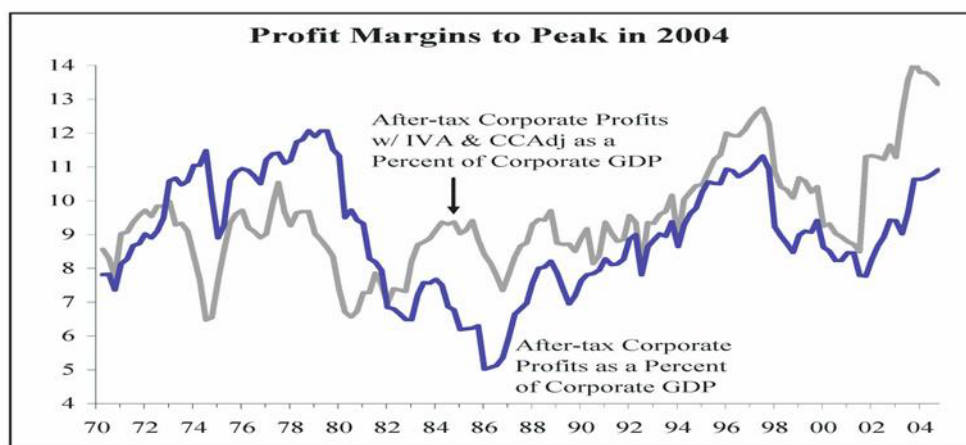
Hal Peterson—Chief Investment Officer
Matt Jachimciak—Portfolio Manager

Few trends in the financial markets or economic research hit the analyst over the head. Most are subtle, stealthy, and leave room for healthy debate. The general downward direction of corporate tax rates is fairly obvious, but we are trying to find specific support for our position that one of the major contributing factors to rising corporate profits in the U.S. has been the decline in tax rates. Our view is that rates may not go much lower. We have seen data that suggests that average corporate rates are in the 20% range currently, which is not completely consistent with what the IRS is showing as historical corporate income tax rates since 1909, the inception of the corporate income tax. (*"The disclaimer in this article is that "taxable income" throughout the years has meant many different things, so the rate brackets are not comparable from year to year."*) So, if what the IRS historical data is showing is the actual effective rate, in our opinion, we are at historic lows for what we consider a contemporary economic period from the late 1950's. When combined with rising labor costs, a better employment picture than the common measure of initial jobless claims sug-

gests (it doesn't consider the increasing size of the labor force), and the diminishing marginal returns from productivity, all are converging to suggest that **profit margins in the U.S. might be about as good as they get.** But, how sustainable is the current recovery and what happens next?

One of Warren Buffet's favorite ratios is Net Income as a Percentage of Gross Domestic Product. This is a good way to look at margins. Since about 1960 after-tax margins have been in a range of 4% to 7% with the average being 5.4%. Currently margins are at 6.3% of GDP. The ratio reached a low of 4.7% at the bottom of the recent market correction. What we are suggesting, is that this margin recovery may have just about run its course. For example, GDP rose by 10.5% since the market bottom while earnings increased about 50%, this is only possible with margin expansion. **When the inevitable return to "normal" happens, the leverage will work in the opposite direction and this is what we think the market is currently unprepared for.** To put it into perspective, if margins declined back to the historical 5.4% average, revenues would have to rise by almost 17% just to keep earnings at current levels. That would require revenue growth of about 4 times economic growth. In our view, that doesn't seem very likely. ■

The Earnings "Sweet Spot" Earnings and Economic Growth to Converge



Source: Morgan Stanley Research, Bureau of Economic Analysis. Note: 2Q04-4Q04 are Morgan Stanley estimates. IVA = Inventory Valuation Adjustment; CCAdj = Capital Consumption Adjustment.

- **Earnings momentum is still strong.**

Below are relevant market indices for the quarter ended June 30, 2004:

Market Indices	2nd Qtr	Y-T-D	1 Year	3 Year	5 Year	10 Year
LB Credit Bond Index	-2.44%	0.15%	0.33%	6.36%	6.95%	7.39%
Dow Jones World Index	0.37%	4.45%	26.38%	2.40%	-0.12%	7.18%
S&P 500 Index	1.71%	3.44%	19.10%	-0.70%	-2.21%	11.83%
Russell 2000 Index	0.47%	6.76%	33.35%	6.23%	6.63%	10.92%
NASDAQ Composite Index	2.69%	2.22%	26.19%	-1.76%	-5.28%	11.54%
MSCI EAFE Index	0.44%	4.86%	32.85%	4.25%	0.40%	4.38%
MSCI Emerging Markets Index	-9.57%	-0.78%	33.51%	13.10%	3.27%	1.20%
NAREIT Equity REIT Index (real estate)	-5.81%	5.51%	26.95%	15.33%	14.49%	12.06%



The chart below provides the gross returns as of June 30, 2004 for structured Dimensional model portfolios that we use as benchmarks for client portfolios. The model portfolio illustration below provides recent history as to how diversified portfolios perform. When comparing the indices above to the model portfolios below, one can quickly see the value of diversification. The goal at SCA is to implement portfolios for our clients with lower volatility, which over time provides enhanced returns. The model portfolios below are rebalanced monthly and do not take into account transaction fees, which differs from actual portfolio activity.

Diversified Portfolios	2nd Qtr	Y-T-D	1 Year	3 Year	5 Year	10 Year
Fixed Income (0% equity, 100% fixed)	-2.06%	-0.24%	-0.54%	4.43%	4.92%	5.91%
Income (20% equity, 80% fixed)	-1.67%	1.10%	5.64%	5.91%	5.75%	7.24%
Income & Growth (40% equity, 60% fixed)	-1.28%	2.46%	12.15%	7.28%	6.48%	8.49%
Growth & Income (60% equity, 40% fixed)	-0.90%	3.80%	18.94%	8.56%	7.13%	9.68%
Growth (80% equity, 20% fixed)	-0.52%	5.17%	26.11%	9.70%	7.68%	10.78%
Equity (100% equity, 0% fixed)	-0.15%	6.54%	33.64%	10.72%	8.13%	11.81%

The model portfolios above are rebalanced monthly and do not take into account transaction fees, which differs from actual portfolio activity. Past performance cannot guarantee future results.

Recent Developments – Family Limited Partnerships

Family limited partnerships (FLPs) are a powerful and often-used component of a variety of estate planning techniques. When properly structured, a FLP may create significant transfer-tax savings through the use of valuation discounts. In recent years, the IRS has successfully challenged the validity of some FLPs, primarily in situations ripe with "bad facts," resulting in full inclusion of the date of death fair market value of partnership assets in the decedent's estate. The Service has accomplished this inclusion through application of IRC § 2036(a), which states that the value of the gross estate shall include any property in which the decedent retains the possession or enjoyment of the property or the right to the income of the property. In addition, the gross estate shall include any property for which the decedent may designate, in conjunction with others, the persons who shall retain the enjoyment, possession, or income of the property. However, § 2036(a) will not apply in the case of a bona fide sale for adequate and full consideration.

In May 2003, the Tax Court revisited *Estate of Albert Strangi* (T.C. Memo 2003-145), also known as *Strangi II*. The Tax Court was ordered by the Court of Appeals for the Fifth Circuit (CA-5) to remand the case to consider the Service's assertion that the gross fair market value of partnership assets should be includible in Strangi's gross estate under § 2036(a). The Tax Court ruled that the partnership assets were includible because the FLP and corporate general partner documents did not prevent the decedent from receiving the income from the assets, and further, the decedent could act in conjunction with other corporate shareholders to essentially rescind the FLP structure, resulting in present enjoyment of the FLP assets. The Tax Court further noted that the facts and circumstances surrounding *Strangi* supported an implied agreement for present enjoyment of the assets by the decedent because, most importantly, the decedent's relationship to the transferred assets was not substantively changed subsequent to their transfer to the FLP. Because the

decedent appeared to disregard the existence of the partnership, the Court did as well. Briefs are due in June for *Strangi II*'s appeal to CA-5.

In a recent pro-taxpayer decision, CA-5 ruled in *Kimbell* (No. 03-10529) on May 20, 2004 that assets transferred to an FLP were not includible in the decedent's gross estate because the transfer represented a bona fide sale for adequate and full consideration. The facts and circumstances of *Kimbell* can be distinguished from those of *Strangi II* notably: (1) the decedent did not commingle personal and partnership assets, (2) she retained sufficient liquid assets outside the partnership to maintain her lifestyle, and (3) significant non-tax business reasons were present that justified formation of the FLP. The Court ruled that the exchange of assets for partnership units that could not be sold for the full market value of the assets given up is a transaction that involves other financial considerations besides recovery of full fair market value in an arm's-length sale to a third party, including management expertise, preservation of assets, and protection from personal liability. Thus, a discounted valuation for partnership units received does not prevent a result of full and adequate consideration received for the assets transferred. The Court ruled that the decedent's transfer of assets to the FLP was indeed a bona fide sale for adequate and full consideration; thus having satisfied the bona fide sale requirement. The Court did not expressly speak to the retained interest provisions of § 2036(a); however, the Court did express that certain facts and circumstances present in *Kimbell* that run counter to *Strangi II* (e.g., maintenance of sufficient liquid assets outside the partnership) support the finding of a bona fide sale.

Although the ruling in *Kimbell* is taxpayer-favorable, it is hoped that the results of the *Strangi II* appeal will provide additional guidance for the application of the retained interest rules of § 2036(a). ■

Practice News

Strategic Wealth Plan™ and Estate Planning Reference Guide

In addition to being a tax advisory firm, Durbin & Bennett also provides various financial planning services, which includes the development of your personalized *Strategic Wealth Plan™*. The purpose of our wealth planning process is to gather information from you and determine your long-term goals, objectives and risk tolerance. Once these are identified, we can estimate a target rate of return needed to fit such parameters. This process typically involves meeting with you two to three times in a workshop setting to evaluate your current financial situation and focus on the key factors needed to achieve your goals and objectives. The customized model created provides a comprehensive framework for making current and future financial decisions from which specific strategies and recommendations can be determined. ■

Another service of Durbin & Bennett is the development of a customized *Estate Planning Reference Guide™*. The guide is a document that compiles all of your financial and estate planning information into one place. It is meant to be a proactive approach to providing your family members a “roadmap” in the event of your death or incapacity.

We often find that one member of a family will be the source for substantially all of the financial and estate planning information. If something were to happen to that person, there is the possibility that the rest of the family would struggle with how to proceed and who to contact. This situation is compounded by the anxiety and frustration of having to accumulate the necessary information “after the fact” which is always more time-consuming and expensive.

The guide includes family information, advisor contact information (such as attorneys, bankers, and investment advisors), asset information, copies of estate planning documents (such as wills, trust documents, and powers of attorney), and general directives regarding succession. We also encourage clients to include a list of the location of important documents that are not incorporated in the guide. Overall, the *Estate Planning Reference Guide™* will give you, your attorney, and your other advisors a comprehensive overview of your financial condition, your estate planning objectives and your succession plan. ■

“Investing is simple, but not easy.”

–Warren Buffet, interview on CNBC

“Saving is a very fine thing. Especially when your parents have done it for you.”

Winston Churchill

To quote the famous investment advisor, Charles D. Ellis,

“The evidence on investment managers’ success with market timing is impressive - and overwhelmingly negative.”

Practice News (cont.)



We are pleased to announce that Strategic Capital Advisors is once again listed in **Bloomberg's Annual Ranking of Top Wealth Managers**, a ranking of leading independent financial-advisory firms. If you would like a reprint of the article e-mailed to you, please contact Mary Verhaeghe at 512.478.0800 ext. 532.

We are proud to announce the addition of Matthew Jachimiak, Portfolio Manager and Rohit Goudar, Securities Analyst to our firm.



Matt is a Portfolio Manager at Strategic Capital. His primary responsibilities include securities analysis, money manager research and evaluation, asset allocation modeling, financial markets research, hedge fund and other alternative strategy research, analysis and evaluation. Matt meets regularly with clients to provide investment advice and counsel. Prior to joining SCA, Matt attended the University of Texas at Austin McCombs School of Business and earned an MBA with a concentration in finance. While at UT, Matt was among an elite group of students selected as Portfolio Managers for the MBA Investment Fund. Prior to earning his MBA, Matt was employed at Enron Corporation in their Analyst/Associate Program. His work experience includes both public and private equity research and analysis. Matt also holds a Bachelor of Science degree in Chemical Engineering from the Colorado School of Mines in Golden, Colorado and is a Level III candidate for the Chartered Financial Analyst (CFA) distinction.



Rohit is an investment management intern at SCA. His primary responsibilities are to support the Chief Investment Officer and Portfolio Manager in conducting securities analysis and returns-based attribution analysis for the investment management research and consulting practice. Rohit is a second year student at the University of Texas at Austin McCombs School of Business where he is working toward an MBA with a concentration in finance. He has earned an MS in Computer Science from Central Michigan University and a BE in Electrical Engineering from Karnatak University in Dharwad, India. He has previously worked with Hughes Network Systems and Raytheon.

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