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THIS ISSUE...

Why Do We Yearn for Forecasts?

Mike Palmer, CFP®

Who do you think will win the game? Is it going to rain this weekend? Is now the right time to move money in my 401(k)? In nearly all facets of everyday life we seek patterns and make minute predictions, some so innocuous we don't even realize them. Do I have enough time to turn in front of that car? Should I buy that dress now or hope it goes on sale in a few weeks? The vast majority of these decisions have very immediate consequences. In two hours the game will be over and we'll know if our team won or lost. Tomorrow, it either will or won't rain. Research indicates the sooner our forecasts are determined (whether right or wrong), the greater our belief in our ability to forecast. This constant feedback loop doesn't always serve investors well.

Our hard-wired, reflexive brains are built for binary thinking. Tens of thousands of years ago yes/no or good/bad decisions served our ancestors very well on the African veldt. It stands to reason that computers have their origins in binary circuits; codes read every bit of data as either "on" or "off" (in computer speak a "0" or a "1"). In fact the computer term "bit" is short for binary digit.

But when it comes to matters of personal finance, where numbers are a means of keeping score, the certainty and precision we typically find in mathematics eludes us. Understanding the limitations and the perils of forecasts, and the shortcomings of our reflexive brains is the first step in becoming better investors. Here are a few keys I believe lead to better decision making when it comes to matters of personal finance:

>> The simple solution, more often than not, trumps the complex.

>> Leverage amplifies risk (exponentially, not incrementally)

>> People who claim an ability to consistently gain a sizeable advantage over the market shouldn't have a monetary need to do it for others and certainly don't need to write books, give seminars, or become a TV talking head about how to do it.

>> Successful investing relies far more on an ability to temper emotion during periods of market euphoria and panic than it does on an ability to accurately forecast the future.

>> A trusted advisor talks about uncertainty without apology. The honest truth is the future is fundamentally unknowable and the sequence of future investment returns unpredictable.

>> Investor behavior is a far more important factor to a successful investment experience than is investment performance.

NOTABLE QUOTE

"I never met a man who could forecast the market."
– Warren Buffett

Trust Company of the South...because wealth management is more than managing money

Regulate… Don't Relegate

by John Slayton, JD/MBA, LLM-TAX, CFP®, AEP, CTFA

The economy and the stock markets are a mess. Trillions of dollars of wealth have evaporated. The taxpayers are on the hook for more trillions of dollars in bail-outs of failed financial giants. Retirement assets have been devastated and the future quality of life for millions of current and future retirees is in question. It should come as no surprise, then, that Congress and the Obama administration are working on sweeping reforms to financial services regulation.

President Obama recently proposed regulation of derivatives, the exotic, complex (beyond understandable) and opaque financial contracts that were originally designed to mitigate risks of interest-rate swings or defaults, but instead nearly crippled the world's financial markets. Threatened failure of American International Group (A.I.G.), the world's largest insurance company and a counter-party to billions of dollars of derivative contracts, risked toppling the entire financial system. Bailing out A.I.G. has cost the taxpayers $189 billion to date.

Derivatives were able to cause such havoc because they were exempted from any effective regulation in the Commodity Futures Modernization Act of 2000 (CFMA). Stewarded by then Senate Banking Chairman, now investment banker, Phil Gramm, Congress passed CFMA, attached to a crucial appropriations bill, at the very close of the 2000 session, without the benefit of any floor debate. The Commodity Futures Trading Commission ("CFTC") had lobbied to regulate derivatives, but Fed Chair Alan Greenspan, Treasury Secretary Robert Rubin (of Goldman Sachs and Citicorp fame) and Senator Gramm (now Vice-Chair of UBS and very active in the derivatives business) supported an exemption from any federal regulation, even feeling the need to exempt the issuance and trading of derivatives by Wall Street from the New York state anti-gambling statutes. The derivatives market was freed of pesky regulation and able to grow to more than $680 trillion by the end of 2008.

The SEC joined the de-regulation frenzy in 2004, revoking the 1975 vintage 12:1 debt to net capital rule, allowing the top five brokerage firms to multiply their leverage several times over (up to 50:1), allowing more derivative creation and balance sheet weakening. Similarly, Congress and several Administrations encouraged/mandated forays by Fannie Mae and Freddie Mac into the risky derivative and sub-prime mortgage markets, in order to encourage broader home ownership by disadvantaged borrowers. These involvements blew up when real estate started to fall in 2006, forcing the taxpayer takeover of Fannie and Freddie last year. Clearly the federal government has been a willing and active partner with the "Wizards of Wall Street" in creating the house of cards that collapsed and caused such unbelievable damage.

The SEC has recently revoked the changes to the net capital rule and Congress is busy holding hearings on a myriad of regulatory issues, so the corral gate is being closed, although the horse is long gone. Last year, the Bush administration suggested a reorganization of federal regulation of the entire financial industry. A super-regulator (the Fed) is proposed to serve the "beat cop" role for all financial institutions. Broad support exists for repeal of the 1999 Gramm-Leach-Bliley Act, which removed the Great Depression-vintage Glass-Steagall Act barriers between commercial and investment banking activities, facilitating a "level playing field" for all market participants to compete in all financial products. Removing historical barriers, without effective regulation, is a recipe for abuse and disaster.

The risk of this pro-regulatory fever is that the Democratic majority in Congress will join with the Obama administration to further a "bigger government is better" solution to our current economic malaise, squelching any minority conservative counter-arguments. Our current financial regulatory structure, including derivatives, must be reorganized and improved, to avoid another debacle such as we have just suffered. However, *this issue is too important to all of us to have it relegated to the status of just another partisan tug-of-war.* Certain issues require our elected representatives to rise above the "business as usual" political process. The legislative majority must maintain prudent financial regulation as its goal, not long-standing political dreams unrelated to a sound financial system. Hopefully President Obama's chief of staff, Rahm Emmanuel, was kidding when he said that this crisis was "too good to waste" in accomplishing the administration's legislative agenda. *Regulate prudently… don't relegate financial regulation to the typical Washington minuet.*

Estate Planning Strategies in a Bear Market

by Jay Eich, CPA, CFP®

The current recession presents a rare opportunity to transfer assets to beneficiaries at depressed values. In 2009 an individual can die with an estate of $3.5 million before estate tax is imposed. An alternative to transferring assets at death to beneficiaries is to transfer a portion of one's estate while living. The IRS allows a $1 million lifetime gift tax exemption that is subtracted from the available estate tax exemption upon death.

One advantage to transferring assets during life to beneficiaries is that it removes future appreciation from the estate. For example, if an individual gifts $13,000 (the 2009 annual gift exclusion) of various securities today to a beneficiary and the assets grow to $50,000 in 15 years, the individual will have removed $37,000 of growth from his/her estate. The benefits obviously increase significantly by gifting more than $13,000, but the gift amount that exceeds the annual exclusion is subtracted from the $1 million lifetime gift tax exemption.

While gifting $13,000 is a fairly simple technique, there are many more complex estate planning strategies. One planning technique gaining the attention of the Obama administration is a vehicle known as a grantor retained annuity trust (GRAT). A GRAT allows one to gift future appreciation on property placed in the trust while retaining the property's initial value. The IRS calculates a rate of return over the life of the trust, but if the trust assets provide a higher rate of return than the calculated rate, the trust beneficiaries receive the difference at little or no gift tax cost. Typical assets placed in a GRAT include stock and other highly appreciating assets.

If the trust grantor dies during the trust term, the asset falls back into the grantor's estate. For this reason, and to incur little to no gift tax liability, a popular planning technique is to create a series of two year GRATs. Currently, the Obama administration is proposing a minimum GRAT term of ten years. Therefore, if a shorter term GRAT is applicable, now is the time to consider implementation.

Another popular strategy is creating a family limited partnership (FLP). For business reasons one may want to transfer a minority interest in a business or portfolio of securities to a FLP. When the limited partnership interests are gifted to beneficiaries (such as your children) restrictions are typically in place that will limit the beneficiaries' ability to transfer the interest or take distributions. Due to the restrictions and the fact that there are multiple limited partners the value of the interests are not as valuable as they would be if the assets were held outside of the partnership.

For example, for business purposes, assets valued at $500,000 are transferred to a FLP. When these interests are gifted to the children, the IRS may allow a discount and the grantor will report a gift of $400,000 (as opposed to the higher value of $500,000). In this example the discount taken is 20%. The Obama administration is currently considering limiting the above-mentioned discounts in FLPs, and would nullify the benefits of creating such a structure.

If you are charitably inclined, a charitable lead trust (CLT) also performs well in a low interest rate environment if the potential for growth of the assets is significant. To implement, one transfers securities to the trust for a set number of years. Payments are made annually from the trust to a charity or charities of the grantor's choice. At the end of the trust term the remaining assets pass to a family member or other non-charitable beneficiary. Similar to a GRAT the IRS sets a rate to project the trust's growth and help determine the taxable gift tax cost to the grantor. Performance exceeding the IRS growth rate passes to heirs tax free.

Plenty of wealth management strategies may be applicable to you during various types of economic environments. Please feel free to reach out to us if you have questions on these or other estate planning issues.

A Rouges Gallery of Recent Financial Forecasts

"I'm expecting another above-average year ahead, an easy one." - Ken Fisher, chief investment strategist Fisher Investments, Forbes December 10, 2007

"I think the stock market has a chance to have a positive return in 2008, but I don't think it's going to be robust." – David Joy, chief market strategist RiverSource Investments, Wall Street Journal January 26, 2008

"My bet on Fannie: Swallow hard and stand firm with your mortgage stocks (Fannie Mae and Freddie Mac)." – Lisa Hess, investment manager, Forbes September 15, 2008 *(In the richest of ironies, the US government instituted a takeover of both entities on September 7, 2008 making this forecast obsolete **before** the publication date)*

"I now realize that in an unexpectedly bad global economy, the combination of rising inflation, commodity dependence, and particularly high export ratios leave them (emerging markets) more vulnerable than I had thought." – Jeremy Grantham, chief market strategist for asset manager GMO, Wall Street Journal August 1, 2008. *(Emerging markets are up over 40% in the first half of 2009)*

Behind the Scenes at Trust Company of the South

>> **Brad Sutton**, TCTS Director of Operations, is serving as the President of the Innotrust Users Group. There are approximately 70 active members, representing approximately 20 financial institutions.

>> **Mike Palmer** was featured in a letter to the editor in the June 14 Work & Money section of the Raleigh *News & Observer.*

>> Trust Company mourns the loss of founder and director emeritus, **J. Harold Smith**, who passed away at the age of 96 on January 31, 2009.

>> Director **F.D. Hornaday, III** was recently named Chairman of the Board of the Alamance Regional Medical Center.

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