[the*compass*] spring 2009

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Is the Bell Tolling for Buy and Hold?

Mike Palmer, CFP®

As anyone can attest, the last six months provided investors with a crucible test unlike any I've experienced in my two decades as a financial advisor. Many of the basic foundations of modern investment strategy have been called into question. Diversification and asset allocation, two fundamental principles we apply to our investment portfolios, offered little protection during the recent decline as all equity asset classes suffered negative two standard deviation returns in 2008. Several pundits have even gone so far as to pontificate that the market of 2008 marks the end of buy and hold investing. We believe separating fact from opinion and anecdotal data from empirical evidence is required if we are to learn from past events.

The principle behind buy and hold investing starts with balancing a client's risk tolerance and desired return. Among the variables that we consider in this equation are the client's age, life expectancy, margin for error, income sources, size of portfolio, income needs, and investment experience. No advisor can predict the sequence of investment returns, and the sequence of those returns impacts investors differently. A newly retired sixty-four year old investor with an anticipated 29 year life expectancy is far more effected by the sequence of portfolio returns than a fifty-two year old executive in her peak earning years. Our emphasis on creating an adequate "safety cushion" for those in or approaching retirement is critical for managing the unknowable sequence of returns issue.

Ancillary to the sequence of returns is the principle that risk and return are related. There simply is no "free lunch" when it comes to investing. Investors desiring a 10% return must be willing to accept the possibility (and as we've witnessed, the actuality) of declines of 50% (or more!). Perhaps nowhere has the concept of magical downside protection been more over-hyped than in the hedge fund universe. Following the 2000-2002 bear market, hedge funds proliferated like Topsy, based largely on the claims that alternative asset classes provided lower correlations and downside protection. However, the empirical evidence (see accompanying chart) suggests that hedge funds' correlation to the overall market actually

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NOTABLE QUOTE

"Each crisis has its unique features – the nature of the shock, the object of speculation, the form of credit expansion, the ingenuity of the swindlers. But if one may borrow a French phrase, the more something changes, the more it remains the same. Details proliferate; structure abides."

– Charles Kindleberger

The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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

increased during the last quarter of 2008, at a time when non-correlation and downside protection was most needed.

We'd be the first to agree that markets, like ecosystems, are not static. The relationships between asset classes, the perceived risk of investing in equities, and expected returns are constantly changing. But we must ask ourselves can we add investment value (higher returns) consistently through asset movement? We are skeptical of this proposition. In constructing investment portfolios we must focus on what we can control. We control which building blocks (asset classes and funds) and how much of each we use. We can control fees (which are a direct drag on returns) and use building blocks that are low cost.

Our predictive powers are sketchy at best (as are those of other advisors) and can be harmful at worst. Regardless of what an advisor may contend, the ability to consistently move in and out of investments adroitly hasn't been documented by any empirical evidence. If the risk of harm is equal to or exceeds the risk of benefit, is this something we should undertake on behalf of our clients?

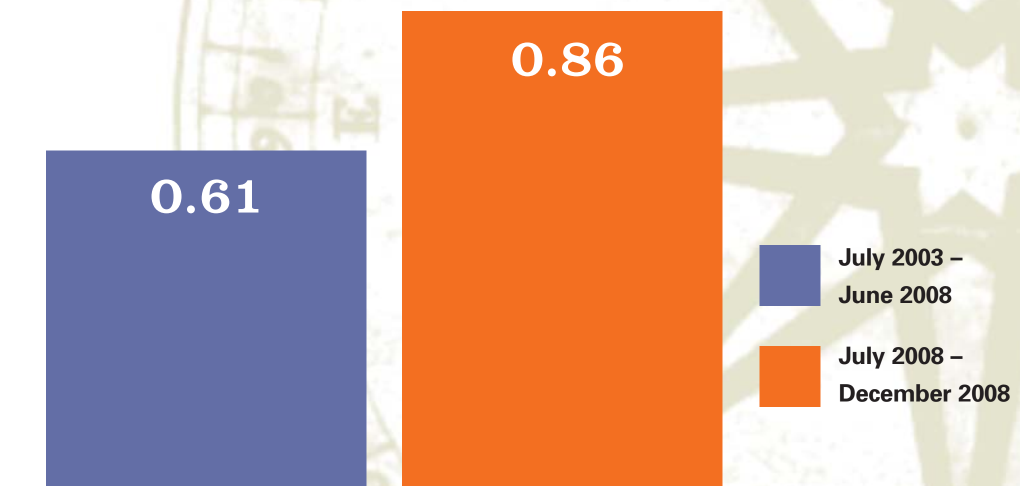
There are, however, lessons to be learned from the recent past. We can do a better job of aligning a client's portfolio with the appropriate risk relative to their asset needs. Tracking one's retirement nest egg against anticipated future withdrawals in the same fashion pension liabilities are tracked may provide an over/under funding amount. If the future liability is overfunded, equity exposure could be "dialed back." If underfunded, equity exposure should be "dialed up."

In addition, monitoring exogenous factors and considering the impact these factors could have on the investment landscape may provide opportunities to tilt portfolios in a way that reduces risk. We should also be particularly attuned to the concept that the expected return of equities seems to be inversely related to investor risk appetite.

In summary, we don't believe the fundamental precepts of modern investment strategy are broken. Diversification is critical, significant "movement" of portfolios rarely produces positive results and should be undertaken with the utmost judiciousness and with a guiding principle of erring on the side of doing no harm to the client's portfolio.

How Alternatives Really Perform in a Down Market: The "Advertised" Downside Protection Disappeared

HFRI FoF Composite Index vs. S&P 500



Correlation is the statistical measure of the commonality of performance in two different investments. The blue box illustrates the correlation between HFR (hedge fund index) and the S&P 500 between July 2003 and June 2008 when the S&P 500 returned 7.5% annualized. The orange box shows that during the market decline in late 2008 the correlation between the HFR and S&P 500 actually increased by over 30%. The downside protection alternatives supposedly provide didn't materialize when it was most needed.

But I Don't Feel Stimulated…

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

President Obama recently signed an $800 billion Stimulus Plan and submitted his 2010 Budget to Congress, resulting in a $1.75 trillion+ increase to the federal deficit. The President hopes to halve the budget deficit within 4 years, partially through new taxes. Americans making over $250,000 annually will fund up to $700 billion in additional tax revenue over a 10-year period:

>> Expiration of Bush tax cuts – $338 billion
>> Elimination of itemized deductions – $179 billion
>> Raising capital gains tax – $179 billion

The recent debate over how to deal with the deepest recession since 1930 has focused on the differences between two historical economic approaches – *Supply-Side vs. Demand-Side Economics.* It is tempting to dispatch such debates as academic, partisan dribble, but the outcome is going to have a real impact on our wallets and lifestyles for years to come.

Supply-Side Economics, as popularized by Ronald Reagan and espoused by economists Milton Friedman and Friedrich Hayek, argues that tax cuts to high bracket taxpayers spur investments in the private sector, thereby increasing the supply of goods and employment. Increasing *supply* drives down prices, increases *demand* and results in increased economic activity, which results in added tax receipts. In 2001, the Bush tax cuts decreased tax rates and produced higher tax receipts. On the other hand, the President and the Congressional majority have firmly embraced *Demand-Side Economics*, as sponsored by John Maynard Keynes during the Great Depression. Keynes argued that jumpstarting economic growth requires stimulating *demand* through government spending, tax cuts and rebates to the middle class, so that they *demand* and spend more. Employment is closely correlated with aggregate demand for consumer goods, so during recessions the government should borrow money and spend it in order to drive the economy. The "Keynesian Multiplier Effect" posits that real GDP rises by more than the actual government spending, because idle resources – unemployed labor and capital – are put to work to produce added goods and services. The Obama budget assumes a multiplier of around 1.5, meaning that every $1.00 the government spends on "shovel-ready" projects and lower/middle class tax credits results in $1.50 benefit to GDP and every 1% improvement to the GDP results in 1 million jobs.

During the Great Depression, Keynes argued that with consumer and business spending so weak, governments had to boost demand directly. FDR's public works programs and the increased government spending during and after World War II eventually ended the Great Depression. Keynesian policies were popular until the late 1970s, when government spending was blamed for spurring worldwide inflation. *Supply-siders* argued government deficits drive up interest rates and rob capital from the private sector. During the 1980's shrinking government became the predominate goal. Monetary policy played a bigger role than fiscal policy, as central bankers drove up interest rates in order to fight inflation. The last 25 years became known as "the Great Moderation," with less volatility in economic activity and inflation. Unfortunately, monetary policy has not and will not cure the current economic crisis.

The Obama Administration and the Democratic Congressional majority are trying to cure our economic woes with increased discretionary spending. Unlike the 1930s, however, discretionary infrastructure spending has been marginalized by huge entitlement spending (Medicare, Medicaid and Social Security) and is no longer an effective fiscal tool. Government borrowing to stimulate the economy today will result in higher taxes or higher inflation (or both) in the future. We'd contend incentives (reduced marginal income tax rates) for people and businesses to invest are more effective than massive government spending programs. Government spending that diverts capital from those who are productive and redistributes it to politically favored interests assumes that government excels at capital allocation. Income redistribution through a Trojan horse of Democratic policies, cloaked as Stimulus, should not be confused with sound economic theory. In reality, no one spends someone else's money better than they spend their own. The Stimulus Package is all about politics and power, not sound economic theory. To be informed is to be empowered.

Behind the Scenes at Trust Company of the South

>> **Cameron Shirley,** daughter of TCTS employee Lisa Shirley, and a senior at Apex High School, was awarded the North Carolina Teaching Fellows Scholarship at Elon University.

>> **Jay Eich** joined the Finance Committee of the First Tee of Charlotte. The First Tee works with children to promote character development and life-enhancing values through the game of golf.

>> **Mike Palmer** was quoted in the January issue of *Financial Advisor* magazine on dealing effectively with clients suffering from dementia.

>> We are pleased to announce that **Mitchell Paul, CPA** has joined the firm in our Burlington office as a Principal. Prior to joining Trust Company Mitchell was Managing Director with U.S. Trust in Raleigh.

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Madoff and Stanford: Know Your Advisor

In the span of two months we've witnessed the implosion of two financial advisory firms. While the impact of Bernie Madoff has been minimal in our market, you may know of friends, relatives or neighbors that have been impacted by the recent problems at Stanford Financial Group. We've heard from a number of Stanford clients directly, as well as attorneys and CPAs with clients adversely impacted by the Stanford situation. After significant efforts, we have enjoyed some initial success in assisting clients to free their assets from the various unfortunate legal entanglements. While we agonize over the plight these clients find themselves in, we also understand the need to make good, sound decisions going forward.

As former Stanford clients determine their next step, we think it is important to consider and confirm the capacity in which their financial advisor will serve them. As the fallout continues from the Stanford debacle, never has the distinction between advisors serving in a fiduciary capacity and those serving under a suitability standard been more evident.

At Trust Company of the South, we've long embraced and promoted our belief in the wisdom of serving our clients in a fiduciary capacity. As a NAPFA (National Association of Personal Financial Advisors www.napfa.org) affiliated firm, we sign a fiduciary oath with every client. There is never any confusion about the capacity in which we serve.

If you have friends who've been affected by the Stanford debacle, we hope you'll take the time to remind them of the important distinctions and protections fiduciary advisors provide. A brief summary of the differences may be helpful:

>> Broker recommendations to a consumer must only be "suitable" – not the best, not the most reasonably priced, not the one the advisor would buy. No disclosure of conflicts of interest (a product recommendation providing higher advisor compensation than another "suitable" product) is required.

>> Fiduciary advisors owe a duty of loyalty and trust to the client, to put the client's interests before their own. Conflicts of interest must be avoided, and if they exist, fully disclosed.

Please contact us if you have any questions or need further information.