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THIS ISSUE...

That Old Wall Street Black (Box) Magic

by Mike Palmer, CFP®

One of the benefits to being an "old hand" in the financial advisory profession (now starting my third decade) is that I've seen many investment fads come and go. I've coined a phrase I like to call Palmer's Law; nearly all financial product innovations are driven not by *investor* demand, but by **inventor** (i.e. Wall Street) greed. Over the last decade I've archived articles that tout the latest and greatest investment strategies, with an eye to revisiting them several years later to see how they turned out.

In the mid part of this decade Wall Street became enamored with the concept of "portable alpha." An article in the June 29, 2006 edition of the *Wall Street Journal* quoted Dean Barr, director of alternative investments at Citigroup, as claiming, "We've developed a better mousetrap here," referring to their portable alpha strategy. Investment firms State Street, PIMCO, Goldman Sachs and Morgan Stanley all offered portable alpha strategies, with an estimated $125 billion invested in 2006. The idea behind portable alpha sounded simple enough. Investment managers could get market exposure through investing a portion of their portfolio in derivative instruments such as S&P 500 index futures. This is known as capturing the market return or "beta." The remainder of the portfolio is invested in hedge funds, leveraged, or in some combination in an attempt to "beat the market" or capture alpha.

So how did the better mousetrap work out? Not so well it turns out. An article in the December 1, 2008 *Wall Street Journal* noted the Pennsylvania State Employees Pension fund lost over $3 billion as a result of investments in portable alpha strategies, far more than the S&P 500 during the same period. A comparison of PIMCO's Fundamental Index Plus mutual fund, a portable alpha fund designed to beat the FTSE RAFI 1000 has lagged the benchmark on annualized basis since inception, posting a return of -2.65% v. benchmark of 1.09% through August of 2009.

I'm always a bit cautious when I read of someone touting a "better mousetrap" when it comes to investing, especially if it comes at the expense of greater complexity. My experience has been that the greater the complexity of an investment, the greater the risk, and risk that is less than transparent due to the complexity of the investment.

NOTABLE QUOTE

"History is medicine. It has nothing whatever to do with the past. It has everything to do with the present."
– Ken Burns

The (Financial) Road Not Taken

by Mike Palmer, CFP®

In the spring of 1985 Furman University was in the market for a basketball coach. The Paladins were coming off a third straight losing season, and athletic director (and future NC State football coach) Dick Sheridan and Furman chancellor Dr. John Johns were hoping to find a young coach that could turn around the Furman basketball fortunes. One of the candidates was a little known UNC assistant named Roy Williams. Williams had aspirations of being a Division I head coach and the Furman job had appeal since he had grown up about an hour away in Asheville. Williams was an attractive candidate, given his ACC pedigree and Dean Smith's endorsement.

During his interview at Furman, Williams was asked by Chancellor Johns if he were offered the job whether or not he would he take it. Williams writes in his autobiography, "I said, Dr. Johns, I can't answer that because it hasn't been offered. Right now I'm more interested in my North Carolina team beating Auburn than I am this job. But you've got to believe that if I do get this job that I'm going to be more interested in Furman winning than any other school." Williams ended up being passed over for the job in favor of another candidate.

The rest, as they say, is history. Williams served as a UNC assistant for three more seasons before taking over as head coach at Kansas with no previous college head coaching experience. His combined record at Kansas and UNC is 589-138 and two national championships. Furman's record over the same time period is 264-314 and no NCAA tournament appearances under four different head coaches. One wonders what might have happened had Williams ended up at Furman in 1985 instead of Kansas in 1988.

The financial choices we make offer some parallels to Williams' journey and Furman's quest for basketball success. For starters, some of the best financial decisions are the ones we pass on. Investment guru Warren Buffett is famous for likening investing to a baseball hitter with no umpire; he can wait for a fat pitch without any fear of passing on a pitch that might be called a strike. Investment strategies relying on timing or attempting to exploit a fleeting pricing anomaly are more akin to speculation than investing. A lucky few may be able to exploit such extreme outcomes, but the vast majority will not.

And like Furman's experience in hiring basketball coaches, there's no "system" that predicts the talented few capable of success. Furman initially hired coaches with winning records at other schools, only to see their prior success fail to translate into success in the Southern Conference. The last two coaching hires were assistant coaches at big-time programs. That strategy too has failed to deliver even average (.500) results. Separating luck from skill is extraordinarily difficult, be it with hiring basketball coaches or choosing mutual funds.

Behind the Scenes at Trust Company of the South

>> **Michael Paul,** son of TCTS principal Mitchell Paul, has been chosen as Chairman of the 2011 Class Crest Committee at the U.S. Naval Academy. He was also recently named Midshipman of the Month for the 29th Company.

>> **Bill Noble**'s son, Gardner, recently received the rank of Eagle Scout. Congratulations Gardner!

To Roth or Not to Roth?

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

We have previously discussed the new rule permitting conversion of traditional IRAs to Roth IRAs, even if your annual income exceeds $100,000. **The time has come… how do I decide whether, or how much, of my traditional IRAs I should convert to Roth IRAs? Why would I EVER pay taxes now when I could delay until I start withdrawing from my IRA in retirement?**

Consider a conversion to a Roth IRA if:

>> You anticipate paying taxes at a higher rate in the future than you are now. More on this later.

>> You can pay the significant up-front tax hit from non-retirement plan assets. Paying income tax and penalty to generate cash to pay conversion taxes is unwise. To entice us to convert large sums in 2010, special rules allow us to defer paying the tax until we file our 2011 and 2012 tax returns.

>> You have a number of years (at least five) to go before you must tap the Roth IRA, allowing you to get beyond the minimum Roth holding period and to generate enough tax free appreciation to justify the up-front tax hit. While a Roth contribution is not deductible on the front end, it grows and distributes tax-free, a powerful leveraging tool over time.

>> You are willing to pay a tax price now for an opportunity to pass on tax-free income to your beneficiaries, without having to decrease it through required minimum distributions during your lifetime. The Roth IRA is a significantly better vehicle for accumulating assets and passing income tax free assets to beneficiaries than a traditional IRA (that might only deliver 15% of its pre-death value to the heirs, after estate and income taxes). Many affluent retirees have no need for IRA distributions and this is reason enough to convert balances to Roth IRAs.

>> You anticipate a year with low income and tax rate, so that adding your conversion will not bump you up to into the highest brackets.

>> Your main retirement assets are in traditional IRAs and you would like to diversify the tax treatment of your retirement holdings. Having the choice between taxable and non-taxable distributions from Roth IRAs enhances effective tax planning.

The conversion decision in large part hinges on future tax rates:

>> The default rule historically has been that tax rates are higher in your employment years and lower in your retirement years. This may no longer apply.

>> After the Bush tax cuts expire at the end of 2010, the top tax brackets will increase by 3-5% each. The Administration and Congress have both proposed significant additional tax increases.

>> The House proposes to pay for healthcare reform with a surtax on the wealthy. With huge budget deficits and historically low tax rates, increases are coming. The higher the deficits, the higher the tax rates.

>> You may deem it better to pay the taxes from any 2010 conversion at the lower 2010 rates, rather than delay the payment until higher rates are in effect during 2011 and 2012.

>> If you are 15 years away from retirement, it is a tough call today as to where tax rates will be then, and how advisable pre-paying tax is.

>> A nightmare scenario would be converting a large balance to a Roth IRA and paying taxes, only to have Congress change the rules in the future and remove the tax-free nature of Roth IRA distributions. If that sounds unfair, Congress need not blatantly reverse the rules, they could simply cap the tax-free nature or limit the desirability in any number of ways. Large deficits will create large need for tax revenue… nothing will be sacred.

Conversion need not be an all or nothing proposition. Portions of IRAs could be converted so as to manage income to stay below higher marginal tax rates. Congress hopes to collect bountiful income taxes in 2010-2012, but we need not succumb to the siren's song and make wholesale IRA conversions. If you plan to convert and pay resulting taxes in 2010, reduce other 2010 income to smooth out levels

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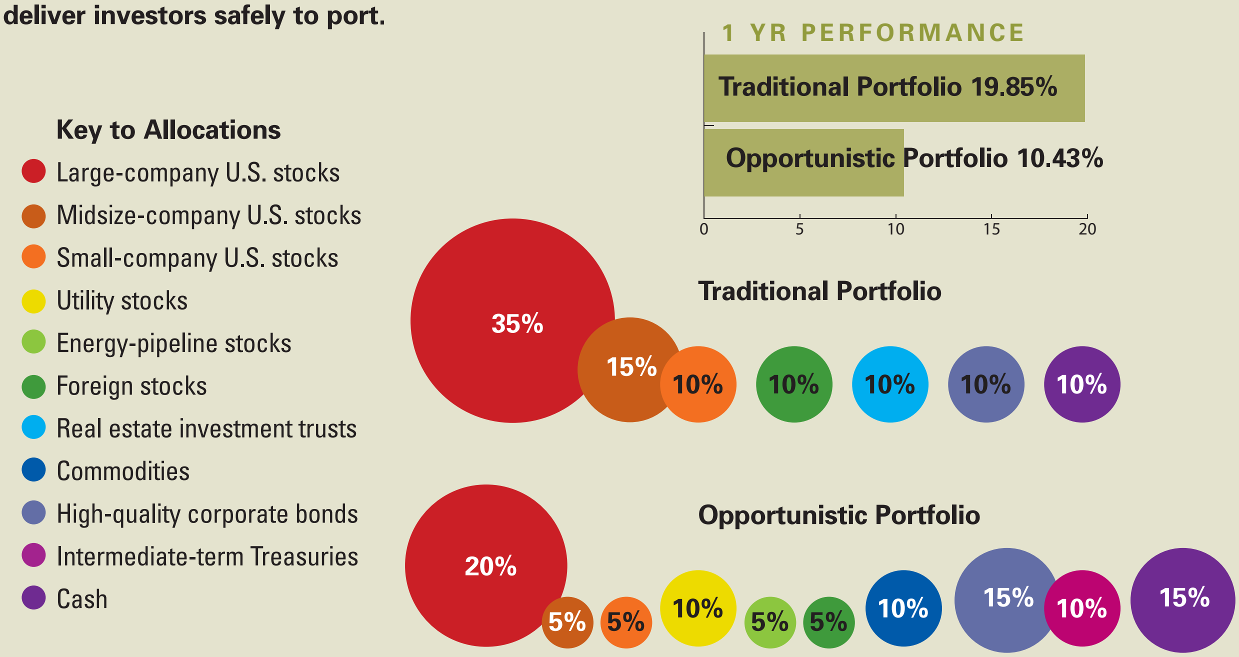
The Worst of Times and the Worst of Timing

The January 2009 issue of *Kiplinger Personal Finance* featured a story titled "The New Rules for Investing Your Money." The article promoted a concept called "opportunistic investing" using unusual asset classes and changing allocations as bargains appear. At a time when the faith of many investors in the very markets themselves was being tested, these concepts might have had seductive appeal. Investing history is replete with examples of the sirens song of fad failing to deliver investors safely to port.



Roth, continued from previous page

between years. This is the opposite of traditional income tax planning, but will smooth income between the two years and should also help minimize alternative minimum tax.

Effective tax planning suggests strategic partial conversions, sensitive to minimizing the increase in tax rates, but resulting in additional flexibility for tax-efficient retirement distributions from both traditional and Roth IRAs. Tax treatment of IRAs can be fully diversified just as investments within them are. This has over-simplified complex issues, but we are available to discuss your specific situation. *Remember, it is not what you make that matters… but rather what you retain after taxes.*

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