The Trust Company of The South

The Compass

FALL 2003

WWW.TCTS.COM

Where Do We Go From Here?

Market Rise Tempts Some to Follow Herd

Inside this Issue:

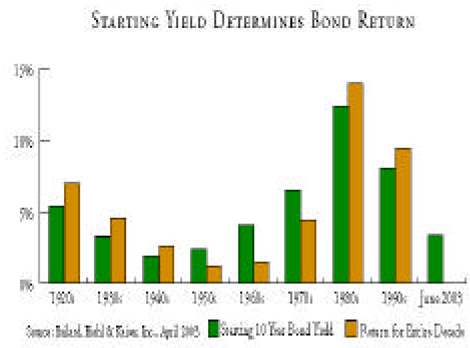
What a difference six months make! During the 1st quarter of this year investors appeared to be suffering under a malaise of gloomy winter weather, three successive years of depressing stock market results, and worries over a looming showdown in Iraq. As we wrote in the Spring edition of *The Compass*, we believed the overwhelmingly negative sentiment in the stock market offered compelling opportunities for investors. We viewed the "reward horizon" as a long one, so the strength of the stock market over the intervening months has been a surprise.

As we often reinforce with clients, we do not attempt to forecast the near term direction of markets. We are merely capitalists that believe our economic system will provide investors returns in excess of inflation over the long-term. Our indifference/ambivalence to the "noise" within the market allows us to make reasoned and rational assessments of the risk/return ratio of various asset classes. It is this "emotionless counterbalance" combined with the objectivity of non-proprietary asset management solutions that delivers value to our clients.

"Got Any Stock Tips?"

At social gatherings I'm often confronted with this question when people discover I'm a financial professional. Many of my industry peers fall victim to the temptation to try and "help" someone and thus make a favorable impression or can't resist the chance to showcase their "expertise" by holding forth on the profit opportunity of pork bellies. Hubris affects us all! There is nothing more exhilarating than to be viewed by others as "smart."

Through experience I've learned the art of being engaging and truthful while avoiding the trap of trying to provide "financial diagnosis" without a full examination of the patient. In that spirit, here's how we see the current financial landscape:



Bonds

We have been cautious on bonds for some time and we remain so. Over the past 12 months the Fed has pumped money into the economy at unprecedented levels. Bond yields are at the low end of the historical range. As the graph above illustrates, the starting yield of bonds is a key determinant of total return. Current yields parallel 1950's & 1960's levels and the results during those periods were total returns (equating to rising interest rate environments) lower than beginning yields (indicating price declines). As a result, we view the risk/return ratio as unfavorable and accordingly are using fixed income instruments primarily to reduce portfolio volatility. Thus, we are keeping maturities very short so as to minimize principal fluctuation.

REITs

As we communicated to clients last month, we recently reduced our weighting on REITs to a 50% underweight. Our clients have been nicely rewarded in REITs over the last 2 years with annualized returns well into dou-

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

800.800.9440

Principals

- John H. Slayton, JD, LLM
- David D. Butler
- William H. Smith, CFP®
- Shannon F. Bradsher
- William H. Noble
- Michael H. Palmer, CFP®

Where Do We go From Here? Continued

ble digits. However, we believe REITs as an asset class are currently overvalued and warrant reduced allocations within portfolios.

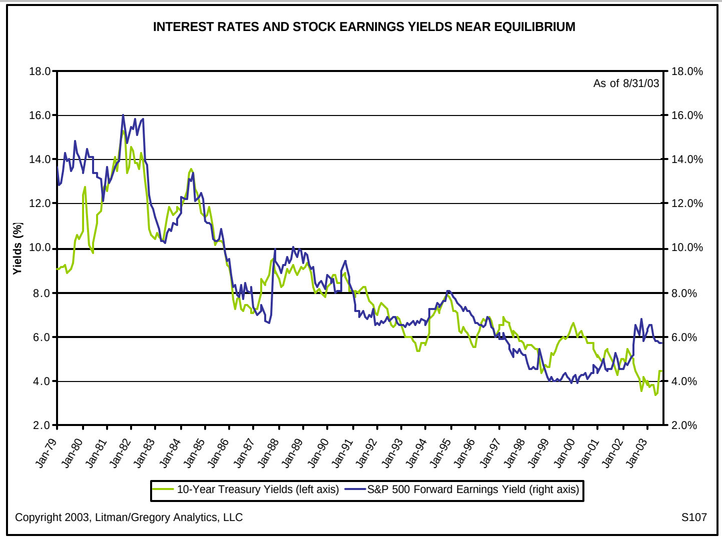
See our website (www.tcts.com) for our September "Asset Allocation Update" which provides greater detail on our REIT decision.

US Stocks

As of the end of September the S&P 500 is up 16% YTD and the Russell 2000 is up 31%. We use a variety of tools in assessing valuation, but perhaps the most straightforward is represented by the chart on the right. We view US equities as fairly valued. Terrorism shocks remain a risk. The economic signals are mixed as to whether the recovery has begun or has legs. Our clients understand the wisdom of our investing approach and share our disdain of market "seers" who advocate timing the market. However, if the reader has fallen victim to these siren songs our advice would be to average into stocks at these levels.

International Stocks

We view international equities as modestly undervalued.



More importantly they serve as significant contributor to reducing the risk of one's total portfolio. Many clients require education on the role international stocks play and why we believe some exposure to this asset class is in our clients best interest. One interesting statistic is the dividend yield on the European index is currently at 3.5, nearly twice the yield on the S&P 500.

New Principal & Income Act Offers Opportunity

In June, Governor Easley signed into law North Carolina's new Principal & Income Act (effective 1/1/2004), based on the 1997 Uniform version, replacing our prior 1962 vintage statute (the "P & I Act"). The P & I Act has two principal purposes: updating rules to cover new situations that did not exist in 1962 and address changes in fiduciary investment strategy dictated by the Prudent Investment Act adopted by North Carolina in 1999.

The major enhancement allows certain trusts to convert income interests to unitrust interests. It also allows trustees to more effectively deal with new types of securities and with pass-through entities such as partnerships or LLCs. Importantly, the power is given to fiduciaries to make adjustments between principal and income, in order to facilitate management of the investments on a total return basis, consistent with the UPIA. If adjustment will not work, the fiduciary may opt to convert an income trust into a unitrust paying a fixed percentage (between 3 and 5 percent) of the fair market value of the trust annually to the income beneficiary, provided no beneficiary objects.

An example may assist in understanding these new powers. A common trust scenario requiring maximum income distributions is a QTIP marital trust distributing all income to a surviving spouse, while distributing the remainder on the death of the surviving spouse to the children, who sometimes are the product of a prior marriage to a different spouse. The fiduciary is confronted with the conflicting interests of the surviving spouse (who desires maximize current income distributions to maintain lifestyle), and the children (who prefer growth of the trust principal). This conflict must be addressed by the fiduciary in today's investment marketplace, consistently with the UPIA's encouragement of total return investing. Balanced portfolios with prudent equity investments may result in great total appreciation over the years, but typically do not produce large amounts of current income from dividend payments. Stocks that offer significant potential appreciation do not typically pay large dividends (Microsoft). This shortfall is compounded by the low interest rates currently available in today's fixed income markets. Where adjustment between principal and income will not work, the income interest can be converted into a unitrust payment. The fiduciary will be free to invest to invest for total return, increasing both the current unitrust payment and the remaining principal.

Understanding the Trust Company Investment Process

“Open architecture” has become the buzz word du jour in the financial services community. Investment advisors want to convey a structure that is free of dependence on a single provider, particularly regarding asset management. Our firm’s “open architecture” structure was in place long before that term become part of the financial lexicon. We believe our success in recent years is in some part a result of the fact that we do *not* offer proprietary asset management, but instead spend time researching, analyzing, and monitoring “best of breed” managers across all asset classes, including both active and passive (index) managers. The discipline we bring to bear avoids chasing “hot managers,” a strategy which historically yields poor results.

We are often asked by prospective clients, “How did you do last year?” There is no standard response, as our client’s performance is in large measure a product of their individual risk tolerance, time horizon, income needs, tax situation, and in some cases existing security concentrations.

What we at Trust Company can clearly articulate is our focus on investment *process* and a belief in adding value to one’s investment portfolio through a well designed asset allocation and periodic tactical adjustments to that allocation as circumstances warrant.

Perhaps an overview of some of the steps we take in evaluating various asset management firms will shed light on how we build a team of complimentary asset management firms for our client’s portfolios.

The most critical step in portfolio construction is the thorough consideration of the individual client’s risk tolerance, time horizon, etc. outlined previously. This serves as the foundation for any recommendation we make.

Our manager due diligence begins with understanding the manager’s philosophy, firm structure and tenure, assessment of resources and personnel, and evaluation of investment performance.

Manager selection involves both art and science. Within the vast universe of managers we believe only a handful have the capability to consistently achieve top quartile performance. We use various statistical measures to analyze risk-adjusted performance. It is important to “look through” the raw performance to assess the manner in which the performance was produced. The statistical measures we use to assess risk adjusted returns include alpha, beta, correlation coefficient (R^2) and Sharpe ratio.

Trust Company of the South
Manager Analytics

	5 YEARS ENDING 06/30/03			
	ALPHA	BETA	R2	SHARPE
LARGE CAP VALUE MGR A	0.98	0.95	0.90	0.03
LARGE CAP VALUE MGR B	1.12	1.08	0.92	0.02
RUSSELL 1000 VALUE	0.00	1.00	1.00	0.00
LARGE CAP GROWTH MGR	4.29	0.80	0.90	0.26
RUSSELL 1000 GROWTH	0.00	1.00	1.00	0.00
SMALL CAP MGR A	6.32	0.89	0.80	0.18
SMALL CAP MGR B	5.07	0.94	0.65	0.18
RUSSELL 2000	0.00	1.00	1.00	0.00
INTERNATIONAL MGR A	3.88	1.02	0.94	0.14
INTERNATIONAL MGR B	3.05	0.86	0.80	0.18
MSCI EAFE - NET DIV	0.00	1.00	1.00	0.00
FIXED INCOME MGR - INTERMEDIATE	0.43	0.97	0.97	0.10
LB AGGREGATE INDEX	0.00	1.00	1.00	0.00
FIXED INCOME MGR - SHORT	1.41	0.09	0.50	-0.94
JPMORGAN GLOBAL FIXED INC	0.00	1.00	1.00	0.00
REIT MGR	0.16	0.88	0.94	-0.04
MORGAN STANLEY US REAL ESTATE	0.00	1.00	1.00	0.00

Standard deviation is a measure many novices focus on to measure risk. Standard deviation simply measures the dispersion or range of returns over a given time period, typically the lower the standard deviation the better. We view standard deviation as a largely irrelevant statistic. After all, a manager or fund that lost 10% a year each year for ten years would have a 10 year standard deviation of zero. This manager has been consistent, but not one worthy of investment. Thus the need for a more encompassing gauge.

Alpha is the measure that indicates the value (if any) a manager delivers above a benchmark. To apply a baseball analogy, it is like comparing a pitcher’s earned run average (ERA) to the league ERA average. We look for managers with consistently positive alphas across various time periods.

Beta is a risk measure that indicates a portfolio’s volatility v. a benchmark. A portfolio with a beta of .9 would tend to move 90% as much as the benchmark. If the S&P 500 went down 10%, the portfolio would theoretically go down 9%.

Sharpe ratio is another risk-adjusted measure that compares performance to a “risk-free” benchmark (3 month Treasury bill).

It is important to note the difference between *variability* of returns and *volatility* of returns. The former compares a portfolio’s returns year over year. The later compares the return relative to something else, most commonly, a benchmark.

There is no one “best” risk adjusted performance measure. Due diligence requires looking at various statistical measures collectively, applying knowledge about the intangibles of the firm (research style and capability, management team, etc.) and making objective decisions.

-Mike Palmer, CFP

JA Web Design

Quotes of the Quarter

"Justice delayed is justice denied."
-William Ewart Gladstone

"The last place I would ever want to go is prison. And I don't think I will be going to prison, though."
- Martha Stewart

Are you an advocate of index investing? If so, we believe Dimensional Fund Advisors (DFA) offers index investors an enhanced passive management solution.

DFA's academically enhanced approach has consistently delivered returns in excess of the relevant benchmarks.

Look for additional information on DFA in upcoming newsletters or visit the DFA website at: www.dfaus.com.

The Trust Company of the South
3105 Glenwood Ave Suite 102
Raleigh, NC 27612

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