THE TRUST COMPANY OF THE SOUTH

The Compass

FALL 2004

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Is Your Financial Advisor a Fiduciary?

Advocacy, Alignment of Interest at Issue

Inside this Issue:

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.

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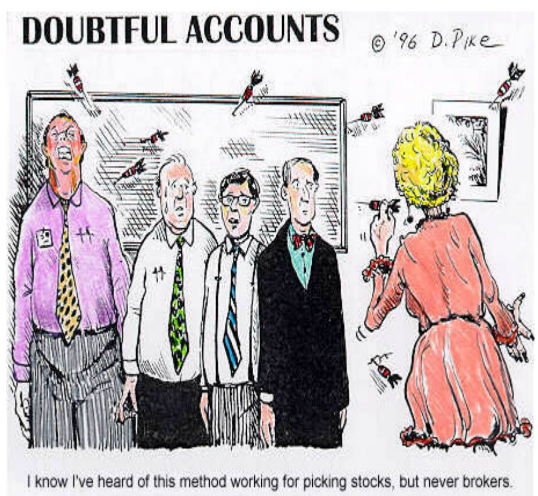
In late July the Financial Planning Association (FPA) filed suit against the SEC for failing to enforce the Investment Advisers Act of 1940 on broker-dealers. Since 1999 the SEC has allowed brokers to provide financial advice without adhering to the 1940 Act. The regulatory agency proposed, but never adopted, a broker-dealer exemption.

The investing public is often unaware of the distinction between a "financial consultant" (the current euphemism for a broker) and a financial advisor. The most dramatic difference between brokers and advisors is the ethical standards governing each. Stockbrokers serve clients under a "suitability" standard of care which requires only that any investment must be suitable for the client. Brokers are not required to disclose any conflicts of interest, nor are they prohibited from self-dealing.

Trust companies and registered investment advisors, on the other hand, are held to the much higher fiduciary standard of care. Fiduciaries must always place the interest of the client ahead of their own. Self-dealing and conflicts of interest are prohibited. "Astute investors understand the valuable benefits associated with a fiduciary standard of care," says noted legal scholar and Yale Law Professor John Langbein.

In addition, the SEC's proposed broker exemption requires investment advice provided by brokers to clients be "incidental" to the sale of securities. When it comes to matters of money, it's hard to believe any reasonable person wants "incidental" advice.

Imagine visiting a general practitioner for a routine physical exam and discovering that heart by-pass surgery was required. "I'll schedule the surgery for tomorrow," the physician says, "surgery is *incidental* to my practice of medicine."



At Trust Company our wealth and financial counsel is <u>not</u> "incidental" to your financial security. Our passion is serving our clients wealth management needs with enduring excellence and unwavering integrity.

- Mike Palmer, CFP®

A Tale of Two Jeremys

It is the best of times, it is the worst of times—depending upon who you ask

With apologies to Charles Dickens, it is the best of times, it is the worst of times – or so say two leading market prognosticators: Jeremy Grantham and Jeremy Siegel. I've learned to read with interest, but for entertainment value only, the musings of market prognosticators. And when two respected minds differ so greatly on their impressions of the market, it only reinforces my belief that such endeavors are simply wasted effort.

Mr. Grantham leads the investment firm of Grantham, Mayo, Van Otterloo, & Company, an investment management firm with nearly $60 billion under management. Mr. Siegel is a well-respected Wharton Business School professor, author of *Stocks for the Long Run*, and a winner of the Graham and Dodd Award. While the two Jeremys share impressive credentials and investment pedigrees, their outlook for the stock market couldn't be more different.

Jeremy Grantham is extremely bearish, as quoted at the Morningstar Investment Conference in Chicago in July: "… the stock market's performance in 2003 was nothing but a brutal rally because it gave investors hope during a bear market that is by no means over. Frankly, my expectation of 2005 being an investment 'black hole' is probably optimistic." Grantham's prediction is for the S&P 500 Index to reach 750, a decline of roughly 30% from today's level.

Jeremy Siegel, on the other hand, is optimistic about stock market returns. He believes stocks will average 5%-6% *after inflation* which equates to 8%-9% returns on average over the next ten years. Stocks are fairly valued, in his opinion, but he believes that price-to-earnings expansion is warranted because of investors increased ability to diversify portfolios at low cost and favorable tax treatment for stock investors. "The average historical PE of 15 is way too low for today's market," he claims in an interview in the July/August issue of *Real Estate Portfolio* magazine.

What is the "average investor" to do if investment "gurus" can't agree on the direction of the market? When it comes to experts like Grantham and Siegel, I'm particularly skeptical of anyone professing such confidence on a subject that simply can't be predicted with any recurring degree of accuracy. **It is an uncomfortable fact that the future is fundamentally unknowable**. One's acceptance of this fact as it pertains to investing is anathema to the American crucible that hard work and keen intellect are ultimately rewarded.

Investors would do well to ignore the "noise" of experts like Jeremy Grantham and Jeremy Siegel. More times than not, such prophecies only deter investors from their long-term goals. To paraphrase Abraham Lincoln, they don't play to the better angels of our nature. Decades of behavioral finance research indicates investor emotion tends to elicit the wrong behavior at the wrong time. Of much greater value is discipline - the courage to confront things as they are.

The best financial advisors understand and accept the unknowable future. They ignore the Wall Street bluster of market timing, sector rotation, and interest rate forecasts. They focus with unwavering laser-like precision on managing client emotions every bit as much as they manage money.

- Mike Palmer, CFP®

Market Commentary

With three-quarters of the year in the books, investors are generally finding 2004 to be much like bath water – lukewarm. One question we often get from clients is, "Do markets drive the economy or does the economy drive the market?" This question is as vexing as Rubik's Cube. Perhaps a Solomonic compromise is the answer: split the baby in two.

There are myriad indicators of a healthy world economy. They include:

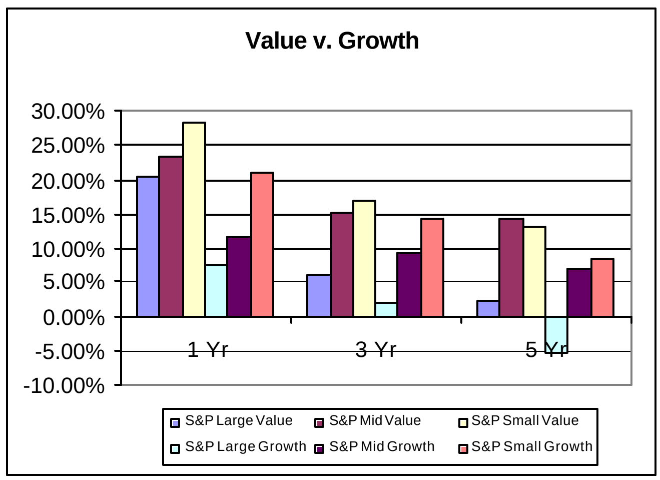
- Global economic growth is likely to come in at a 30-year high for 2004.
- U.S. unemployment claims are low enough to be consistent with a growing, healthy economy.
- U.S. consumer, debt as a percentage of disposable income is quite a bit lower than it is in either the U.K. or Japan.
- Productivity growth remains encouraging.

Earnings for the S&P 500 companies are roughly double year-end 1999 levels.

Improving economic conditions don't seem to be working their way through to the stock market. One interesting theme is the continued dominance of value stocks versus growth stocks across all market capitalizations (see chart). This phenomenon has persisted over five years and our value orientation has benefited as a result. We are inclined to think this trend will continue.

Finally, the question everyone seems focused on - "How might the election impact the markets?" Evidence suggests it is the other way around. There's been much analysis of the election cycle but our view is that the data doesn't draw any conclusions. Ultimately, the economy does impact the financial markets but Presidents tend to have much less influence on the economy than most people think and the candidates claim. There are other variables that, in our view, are likely to play a bigger role in the direction of the economy and the financial markets.

- Mike Palmer, CFP®



Behind the Scenes at Trust Company

- **Bill Noble** was a featured speaker at the Child and Family Services Association quarterly meeting in August.
- **Mike Palmer** is a CarolinaNewswire.com guest columnist writing on personal finance issues. You can read Mike's latest column or see archives of his previous columns at www.carolinanewswire.com.
- **John Slayton** is serving as Chair of the Trust and Investment Subcommittee of the American Bar Association's Banking Law Committee.
- **Bill Smith** and **Mike Palmer** participated in a peer review with Polstra & Dardaman, a fee-only wealth management firm in Atlanta.
- We are pleased to announce the promotion of **Brad Sutton** to Manager of Trust Operations. Brad is a 2000 graduate of UNC-Charlotte and has been with the firm since June 2000.
- **Bill Smith** attended the Association of Independent Trust Companies annual conference in Chicago.

WEB NEWS YOU CAN USE

We are pleased to share useful and informative websites for mutual fund investors. We welcome your feedback on issues you'd like to see us cover in future issues of *The Compass*.

- With all the mutual fund malfeasance that abounds keeping up with the perpetrators requires a mug book. See www.fundpolice.com — a compendium of mutual fund miscreants
- Want to stay abreast of securities litigation? Has your brokerage firm been accused of earning undisclosed third party compensation? See www.securitiesfraudfyi.com
- Fundalarm.com and funddemocracy.com are helpful stops for mutual fund investors.

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