[the*compass*] fall 2005

THIS ISSUE...

Peering Over the Hedge:

Why the Grass Isn't Greener in Hedge Funds

by Mike Palmer, CFP®

As an advisor serving the high-net-worth market, those investors with over $5 million to invest, I'm seeing increasing interest on the part of this market segment in hedge funds. I believe it necessary to discuss the basis for clients' interest and their perceived benefits of investing in hedge funds. With mean variance optimization programs adding the capability to include hedge funds in the portfolio construction process, it may be expedient (and profitable) for advisors to rationalize the inclusion of hedge funds, especially if not doing so threatens the loss of existing clients or potential ones. But rather than acquiesce to clients' desires, true "advising" requires honest assessment and analysis of any investment, especially one as complex as hedge funds.

So how can advisors educate clients about some of the less understood elements of hedge funds? For starters, in nearly 20 years as a financial advisor I've learned that contrarian investing almost always trumps trendy investment strategies. Look no further than the Dot.com bubble as evidence of this fundamental truth, a sufficiently fresh reminder that may give eager hedge fund aficionados pause. Our firm believes a few additional points can help educate clients about the perils of hedge fund investing.

>> **Lack of Regulation:** Say what you will about SEC regulation, but the benefits of regulated collective investments include independent board governance and independent audits. While fraud is possible in any enterprise, it is far less probable and, if committed, far more likely of detection with an annual arms-length financial examination.

>> **Pick a Value, Any Value:** Exchange traded securities enjoy the benefit of transparency. All interested parties can see the value at which willing buyers and willing sellers execute trades. In the hedge fund world month-old prices aren't uncommon and the more esoteric the investment the more murky valuation reliability becomes. As investors in

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NOTABLE QUOTE

"The years teach much which the days cannot know."

Charles Dow

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

Asset Protection Considerations

by John Slayton, CFP®

Clients and prospects in litigation-prone professions (doctors) sometimes inquire as to what asset protection techniques are available under North Carolina law. Assuming you do not wish to move your assets to exotic locales, such as the Channel Isles or Belize, or U.S. jurisdictions such as Alaska or Delaware, what defenses do you have against a judgment creditor for an amount above your liability insurance coverage?

An execution is a formal court process allowing a successful judgment creditor to take a debtor's (your) assets or property in satisfaction of a debt. North Carolina allows its residents to claim certain property as "exempt" from taking by creditors:

1. A $10,000 exemption in a residence;
2. A $1,500 exemption of equity in one vehicle;
3. A $3,500 exemption in any personal property; and
4. A $750 exemption for implements and tools of the trade.

These exemptions must be claimed or risk being waived.

Certain types of property are exempt from creditors' claims:

1. Real estate held with a spouse as "tenants by the entirety," but not jointly;
2. IRAs, 401(k) plans and other qualified retirement plans; and
3. Life insurance on your life that names a dependent as beneficiary.

Estate planning techniques such as annual gifting, use of family limited partnerships and LLCs, funding of minors' educational trusts, and irrevocable life insurance trusts are effective tools to protect assets from individual creditors. Transfers to family members will be scrutinized under the Uniform Fraudulent Conveyances Act, so valid consideration should be received and transfers should be made in advance of judgments against you. While it is not an asset protection hub, North Carolina provides some protections if you plan ahead.

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Long-Term Capital Management found out, valuations of obscure and thinly traded assets can be ephemeral.

>> **Experts, What Experts?:** The recent revelations involving apparent fraud at hedge fund Bayou Capital Management raise questions about the ability of so-called "experts" to adequately monitor and screen hedge funds. *The Wall Street Journal* and HedgeFund.net reported Hennessee Group, a New York based hedge fund consulting firm; JP Morgan, and Silver Creek; a Seattle hedge fund-of-funds firm, invested millions of dollars with Bayou. These firms are well known and respected, presumably with track records of successful investments. Hennessee touts its exhaustive "five phase" due diligence process on its website (www.hennesseegroup.com). The Bayou debacle makes me question the ability of experts to perform proper hedge fund due diligence. If the "experts" can't get it done, what makes an advisor or investor believe he will fare any better?

>> **Birds of a Feather:** High-net-worth investors aren't immune to the behavioral dynamic known as influence or social proof. In fact, since many HNW investors have enjoyed success either by birthright, intelligence, or work ethic, there is the tendency to believe those talents/attributes make them more astute than the "average" investor. This leads many HNW investors to be favorably predisposed to believe that smart financial advisors can identify smart hedge fund managers that will deliver superior performance.

>> **Bad Science:** A common selling point of hedge funds is their low correlations to traditional asset classes. As the son of a biologist, I was taught early in life there is a difference between bad science and bad data. When it comes to hedge

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Investment Focus: PIMCO Floating Income

by Mike Palmer, CFP®

Bond mutual funds are generally misunderstood by most investors. When interest rates rise, bond prices fall. With the Federal Reserve raising the discount rate 11 times over the last 14 months, that "sinking" feeling has been on the minds of fixed income investors and your trusted investment advisors at Trust Company. Earlier this year we began investing some of our fixed income allocation in the PIMCO Floating Income fund (PFIIX) in anticipation of interest rate increases. We view the PIMCO Floating Income fund as a "bank loan" fund surrogate. This sector of the fixed income arena tends to fare better than traditional bonds in rising interest rate environments. As a group, bank loan funds did not experience a down year during the last decade, according to Morningstar.

Bank loan funds avoid losses by investing in adjustable-rate loans. Yields commonly adjust every 30-60 days. There are risks associated with bank-loan funds. Most investments are considered below investment grade. Bank loans are collateralized, so the default risk is somewhat mitigated.

Trust Company of the South has used PIMCO as a fixed income manager for some time. Even though the PIMCO Floating Income fund is little more than a year old, the management team is very experienced and PIMCO has used variable-rate debt to supplement their other bond funds for many years. It seeks to capitalize on attractive investment opportunities offered by these sectors while minimizing interest rate risk exposure.

Key attributes of the PIMCO Floating Income fund include:

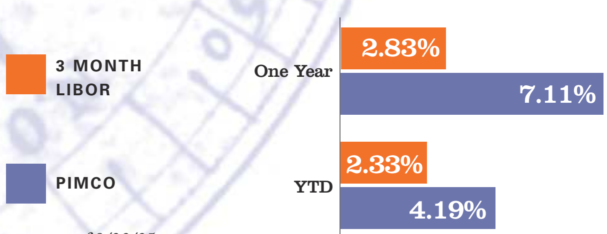
>> **Expenses**: the fund has an expense ratio of just 55 basis points, well below the category average.

>> **Risk management:** the fund has an average credit quality of A-, much higher than the typical bank loan fund.

>> **Superior risk-adjusted returns:** The fund has returned 7.11% over the last year and delivered alpha of 6.69% over the same period..

By focusing on securities whose income tends to rise when interest rates are rising, PIMCO is able to mitigate one of the primary risks of bond investing – interest rate risk. We view the inclusion of PFIIX as providing a complementary defensive component to our fixed income portfolios during a period of rising interest rates.

For more information about this fund, please contact our office to request a prospectus. Past performance is no guarantee of future results.



as of 9/30/05

HOW WE ADD VALUE

I recently received a call from a client who was the beneficiary of a relative's estate. The client's question pertained to permitted executor's compensation and attorney fees. The estate proceedings predated his becoming a client of our firm, but I had some background of what had transpired. During the course of our conversations the client mentioned he and his family had incurred legal fees separate and apart from the legal fees of the estate to insure their interests were protected. "Did you take a tax deduction for those fees?" I asked. "I didn't know I could," he replied. After some further research we discovered that our client (as well as his sibling and parent) was entitled to income tax refunds amounting to several thousand dollars as a result of uncovering this missed itemized deduction.

When we're asked by potential clients why they should retain Trust Company as their trusted advisor, we often pose the following rhetorical questions:

"Does it seem probable that given our firm's collective expertise that we will be able to obtain a greater long-term investment return than you would on your own?"

"Is it likely that we will help you avoid mistakes that might otherwise cost you money?"

"What is the value you place on the time, energy and worry required to manager your affairs presently?"

Our firm's collective talents, wisdom, and expertise as trusted financial solution strategists are why our clients value their relationship with us.

Behind the Scenes at Trust Company of the South

>> In August, **Mike Palmer** and **Bill Smith** participated in a peer review with Abacus Planning Group, a fee-only wealth management firm in Columbia, SC.

>> Kudos to **John Slayton** for his efforts in chairing the North Carolina Bar Association's Legislative Committee with its successful effort to get North Carolina to adopt the Uniform Trust Code. Governor Mike Easley signed the bill into law on July 15th.

>> **Mike Palmer** has been accepted for membership in the National Association of Personal Financial Advisors (NAPFA), the nation's leading organization of fee-only comprehensive financial planning professionals.

>> TCTS Client Services Officer **Aaron Bennett**, and his fiancée, Cydney Furr, were married on July 23. The nuptials took place in Roanoke, VA and the couple honeymooned in Cozumel.

>> **Trust Company of the South** captured 2nd place in the Burlington Times-News Corporate Spelling Bee held September 8th. The event raised nearly $3,000 for Alamance-Burlington School Systems literacy programs. TCTS was represented by **Bill Smith, John Slayton** and **Aaron Bennett.**

>> **Bill Smith, Brad Sutton** and **Linda Paul** attended the Innotrust Users Group conference in New York in September.

>> **Phillip Strickland** has joined us as a student intern in the Raleigh office. He is in his final year at Campbell University completing the MBA / Trust Management program. Welcome Phillip!

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fund analysis, the data may be accurate, but the "science," the conclusion reached, is often specious. When it comes to hedge fund indexes, one would expect the values to be roughly in line. For 2004, The Hennessee Group index was up 8.3% and the CSFB/Tremont index was up 9.6%. But a more stringent index created by S&P (a true investable index, which required included funds to take real cash and hand back profits) was up only 3.9%. According to Forbes, the odds are 1 in 396 that, just by chance, the S&P Hedge Index would be so at variance with the Hennessee average. A study published last year by noted Princeton University Professor Burton Malkiel found that of the 600 hedge funds that reported performance in 1996, only 25% still exist.

The Wall Street Journal reports there are an estimated 8,000 hedge funds managing nearly $1 trillion. The law of large numbers dictates that some, whether by luck or skill, will have impressive returns. But the survivorship bias so rampant with hedge fund data makes any correlation data highly suspicious.

As with other things in life, investment risks are rarely as they seem. The allure of "greener" pastures offered by hedge funds may be more mirage than reality.

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