[the*compass*] spring 2008

THIS ISSUE...

Retirement Checkup 2
Temper Your Emotions 3
Behind the Scenes 4

Derivative Blues

by John H. Slayton, JD, LLM-Tax, CFP®

Today Treasury Secretary Paulson announced the largest financial regulatory restructuring package since the Great Depression. Plans have been underway for some time, but they were certainly accelerated by recent market events. A Republican administration suggesting broad financial regulation might seem unusual, but it is at least in part a reaction to the clamor on Capitol Hill for significantly enhanced regulation as a way out of our current market and economic doldrums. Meanwhile, the Fed has been busy subsidizing a distress acquisition of Bear Stearns, risking $29 billion of taxpayer dollars and, for the first time since the Great Depression, lending money directly to major investment banks. Everyone is asking *"How did we get here, how do we get out and how do we regulate so that it does not happen again?"*

Last time we considered the *shadow banking* system's impact on the market and economy. Within the financial shadows is a huge private market trading complex financial derivative instruments, such as collateralized debt obligations and credit default swaps. These were originally intended as vehicles to transfer risks among parties, but have morphed into some of Wall Street's most profitable products. Derivatives do not trade openly on public exchanges and they are largely unregulated, but they are embedded in the accounts of Bear Stearns and every other global financial services firm. Trades are conducted by phone between Wall Street dealer desks and holdings are largely unknown to investors, analysts and regulators. Warren Buffett has described derivatives as potential "weapons of mass destruction."

The Fed only regulates commercial banks and has not been able to oversee the derivatives market – it has no oversight on activities of the investment banks, hedge funds and other participants in the growing market. Legislation has exempted such private contracts from SEC regulation as well. Even for banks, the Fed has had a difficult time measuring the scale of potential exposure to derivatives and the broader risks banks might face in deteriorating conditions in general credit confidence and liquidity. What started as

continued on page 4

NOTABLE QUOTE

"I blame the system, I blame greed. Wall Street is really predicated on greed. This could happen to any firm."

former Bear Stearns board member Stephen Raphael

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

If Fifty is the New Forty That's All the More Reason You'd Better Get a Retirement Checkup

by Michael H. Palmer, CFP®

Planning for retirement used to be easy. Work for a large corporation, get a pension and gold watch at age 65 and play golf for the next ten years. The "planning" of one's retirement fell to the pension actuaries and investment professionals, and of course Uncle Sam. Just two months ago Kathleen Casey-Kirschling became the first Baby Boomer to apply for Medicare. 80 million more boomers are close on her heels.

However, two major events have conspired to change the way one must plan for retirement: the increase in life expectancy and the shift of financial responsibility from the corporation (pension) to the employee (401-k). Consider these statistics: In 1980, 60% of workers were covered by a pension, today the number is just 10%. In 1960 a 65 year old male retiree had a life expectancy of 12.8 years. Today the same retiree has a life expectancy of 17.1 years (and remember, life expectancy represents the 50th percentile, so half the population lives beyond that age, many well beyond!).

Last week I read a *Wall Street Journal* feature on a 59 year old IBM employee, John Jones. A three-decade veteran of Big Blue, Mr. Jones had planned to retire, but the combination of depressed real estate prices and tumultuous stock market forced him to rethink his decision. While the article didn't go into a lot of personal detail, I found it almost unbelievable that Mr. Jones had only managed to save $240,000 in his retirement accounts, and the article made no mention of an IBM pension. The standard convention of retirement withdrawal rates is 5%. Could Mr. Jones really live a potential 35 year retirement on $12,000 per year plus Social Security?

Unfortunately, too few people engage the services of a certified financial planner to help them analyze their retirement planning and often when they do, it is too late. Just as physicians recommend certain tests upon attaining age 50, so too should consumers get a "retirement checkup" at age 50. It's not surprising to me that I've yet to meet a client who could tell me how much they needed to accumulate in order to retire comfortably and securely. But many were wise enough to know that they needed to do it. Going through the exercise of calculating returns, savings rates, factoring for the randomness of investment returns, and varying life expectancies are all important variables and require a degree of expertise few people other than certified financial planners possess. While the future is fundamentally unknowable, an objective planner can test a range of possible outcomes which can help clients see both worst case and likely case scenarios.

Whether you look to Trust Company of the South to provide this analysis or someone else, we strongly encourage people to seek a fee-only certified financial planning professional. The National Association of Personal Financial Advisors (www.napfa.org) provides a list of quality comprehensive, fee-only planners in your area.

Temper Your Emotions, Stay Focused & Prevail

by William H. Noble, Principal

"Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ. ....What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

- WARREN BUFFETT

As my colleague John Slayton discussed in his article "Derivative Blues," one of the most valuable services we provide to our clients is preventing them from making investment mistakes because of decisions unduly influenced by their emotions.

Technically, most experts agree that a bear market is a market environment that realizes a price decline of 20% or more over at least a two month period. Others might define it as a prolonged period in which investment prices fall, accompanied by widespread pessimism. At the time of this writing, the broad U.S. equity market still has not closed 20% off its October 9, 2007 peak. Whether we are technically in a bear market is debatable. However, most would agree this certainly has been a difficult "bearish" environment and here are some bear market facts and survival tips to help you temper your emotions, stay focused and prevail:

>> There have been 10 bear markets in stocks during the last half century.

>> If history is any guide, bear markets can be expected twice a decade.

>> The market's ups and downs tend to even out over the long run into a steady upward trend.

>> Avoid making sudden "market timing" moves – a market recovery can be just as sudden as a drop. History suggests that it is very difficult to time markets. Remember, exiting out of the market is only half of the story. You also need to "know or time" correctly when to get back into the market. Historically, the market's biggest gains have come from a very small number of days and if you are sitting in cash on some of those days, it makes it that much more difficult to be successful in reaching your investment goal.

>> Avoid the sensationalized financial media. Remember, panic and fear sells…perception rules the short-term every bit as much as reality and substance prevails in the long-term. The media is in the business of "selling" the "crisis du jour."

>> Be patient – the very fact that equities offer better long term returns than bonds and cash is because they are riskier and more volatile…particularly in the short run. However, the longer you hold your equities, the less variability and potential for losses you will be exposed to. The risk of owning an equity is having to sell it at the wrong time.

>> Continue to invest – equities in various asset classes may be a good value in this current environment. Peter Lynch, the famous money manager, was once quoted saying "The worse thing long term investors can do is to get scared out of stocks, and having a diversified portfolio can help you stay committed to your equity investment strategy when stocks struggle."

>> Focus on achieving your financial objectives (rather than on short-term market performance). Own a mix of investments that reflects your goals, time horizon and risk tolerance.

>> Intestinal fortitude (i.e. guts) wins the day. As Mr. Buffett alluded to earlier in this piece, you don't have to be a rocket scientist to be a successful investor. What you do need is a thoughtful, prudent plan and the "guts" to stick to it in difficult environments like the one we are currently experiencing.

In closing, we have been asked quite often "When and where will this bear environment end?" We believe that the answer to both of these questions is not knowable; however, what we do know is that *it will end* at some point and that our experienced advisors at The Trust Company of the South are here to provide ongoing intelligent and prudent counsel to help make your journey a little less bumpy along the way.

The information contained in the Compass is not intended as investment, legal, or tax advice. Please consult with your professional advisor to determine the appropriateness of any strategies to your specific circumstance. Copying this publication without permission of The Trust Company of the South is prohibited. © Copyright 2006 The Trust Company of the South.

Behind the Scenes at Trust Company

>> **Bill Smith** was recently named as Director of the Piedmont Triad Charitable Foundation, which oversees tournament operations for the Wyndham Championship, a PGA tour event which will be held in Greensboro at Sedgefield Country Club in August of this year.

>> **Mike Palmer** has recently been named to the National Association of Personal Financial Advisors (NAPFA) Legislative & Regulatory Committee. NAPFA is an organization whose mission is to promote the public interest by advancing the financial planning profession.

>> **Chris Sutherland, Jay Eich** and **Dan Tolomay** recently attended an informational presentation and seminar by Dimensional Fund Advisors in Atlanta, Georgia.

>> We are pleased to announce that **Robin Yacovetta** has joined our team in Charlotte, North Carolina as a Client Services Officer. Robin was previously with TIAA-CREF and McColl Partners of Charlotte. Please join us in welcoming Robin!

>> **John Slayton** recently attended the Heckerling Institute on Estate Planning, the nation's premiere annual five-day estate planning conference.

DERIVATIVE BLUES, *cont'd*

increased defaults in subprime mortgages last fall extended to the entire credit market, collapsing two heavily leveraged Bear Stearns hedge funds and causing many others to sell assets to raise liquidity. Arguably, the Fed had to bail out Bear Stearns because of its large exposure to the huge credit default swap (derivative) market. Had one of the market's largest players failed, the entire counterparty risk system could have faltered. It is unduly risky that this huge derivative market is totally private and generally unregulated.

This is why we should cheer Secretary Paulson's proposed changes. It is unlikely many will be adopted by Congress during this election year and unknown what a new administration will support, but it is positive that we begin the discussion. The financial world has changed in the last 75 years, but our regulations have not kept up. It makes great sense to regulate activities according to function and impact, rather than by the type of entity providing the service. It makes no sense to have the SEC overseeing stock and bond markets and the CFTC overseeing markets in stock and bond futures, but nobody overseeing the $45 trillion market for derivative contracts tied to those stocks and bonds. We are likely to see a grand turf war between federal and state agencies that will be reorganized, but the old differences between commercial banks, investment banks and insurance companies no longer apply. It is unreasonable to have four different federal bank regulators working with fifty independent state banking and insurance regulators. Further, if investment banks are borrowing from the Fed, why are they not regulated by the Fed? Attempts to modernize our financial regulation to meet the demands of a more complex and risky environment can only be positive for the market as a whole. Noticeably missing from the Treasury's proposal, however, is any regulation of the derivatives market, which today is just as large as the traditional stock and bond markets. Clearly, regulation is justified.

While this discourse is encouraging, the best approach in light of these risks remains a portfolio with a fully diversified asset allocation, designed to meet your short and long term goals. Turbulent times call for prudent, patient investment management. We are here to take the emotions out of the equation.

Raleigh Office

Michael H. Palmer, II CFP®
Principal
919 781.8287
mpalmer@tcts.com

Burlington Office

John H. Slayton, JD, CFP®
Principal
336 538.1000
jslayton@tcts.com

William H. Smith, CFP®
Principal
336 538.1001
wsmith@tcts.com

Rocky Mount Office

William H. Noble
Principal
252 451.8728
bnoble@tcts.com

Charlotte Office

Jay D. Eich, CFP®, CPA
Principal
704 749.3107
jeich@tcts.com

Christopher N. Sutherland, CPA
Principal
704 749.3106
csutherland@tcts.com