THE TRUST COMPANY OF THE SOUTH

The Compass

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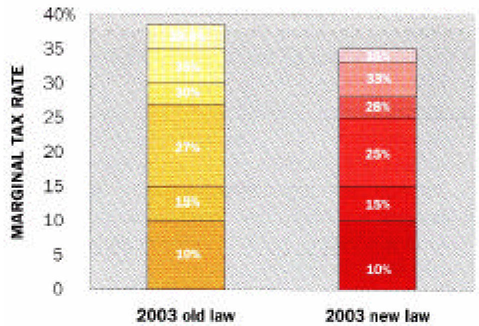
The Trust Company of the South is an independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

800.800.9440

The New Tax Act—What Does It Mean for You?



President Bush recently signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The new law accelerates previously scheduled individual income tax rate cuts, provides capital gain and dividend tax relief and grants short-term tax incentives for certain types of business investment. Here's a brief overview of JGTRRA.

Your Paycheck Just Got Bigger

The new law retroactively reduces the top four rate brackets to the levels previously scheduled to take effect in 2006. Rates drop to: 25%, 28%, 33%; and 35%. Also, the new law retroactively, albeit temporarily, accelerates the expansion of the 10% bracket by increasing the level of income taxed at that rate in taxable years 2003 and 2004. Wage earners will see these rates reflected in reduced tax withholdings starting in July.

Dividends Are A Girl's (and Investors) Best Friend

For many individuals, the new law makes a deep cut in the tax on dividends received in 2003 through 2008. Instead of being taxed at an individual's top bracket-- up to 35%--qualified dividends will be taxed at a maximum of 15% (less for taxpayers in the two lowest brackets). Thus, for example, $6,000 of qualified dividends would incur a tax of $900 instead of $2,100, netting an additional $1,200 return. These lower rates apply to dividends received in taxable years beginning after 2002 and before 2009. The lower rates on dividends apply for purposes of both the regular and alternative minimum tax.

In general, dividends eligible for this preferred treatment must come from domestic corporations or "qualified foreign corporations," including most ADRs. Real estate investment trusts (REITs) will not qualify for the reduced rates however.

A special holding period rule discourages certain short-term trading strategies. In order to qualify for the reduced rates the taxpayer must own the stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date.

Capital Gains Equal Dividends

For most taxpayers the favorable treatment of capital gains v. dividends no longer exists. JGTRRA reduces the top capital gains rate to 15%. The lower rates apply to taxable years ending on or after May 6, 2003. For taxable years that include May 6, 2003, special transitional rules apply for computing the tax.

The lower capital gains rates apply for

(Continued on page 2)

Tax Act, Continued

purposes of both the regular and alternative minimum tax. Estates and trusts also qualify for the reduced rates on capital gains and dividends.

"Marriage Penalty" Relief

Although the 2001 tax cut legislation included "marriage penalty" relief, it deferred implementation until taxable year 2005. The new law temporarily accelerates this relief in taxable years 2003 and 2004.

Alternative Minimum Tax Relief for Individuals

The new law temporarily increases the alternative minimum tax exemption amount for 2003 and 2004 for joint filers and surviving spouses ($58,000) and for single filers and married filing separately ($40,250). These increases are temporary however. In 2005 the exemption amounts are scheduled to drop: to $45,000 for joint filers and surviving spouses, $33,750 for single filers. Like General MacArthur, the AMT shall return!

Estate Planning Implications

Although the new law did not effect any of the estate and gift tax provisions enacted in the 2001, the income tax relief granted will enhance some tax-reduction opportunities that are already part of a client's existing plan. We have long urged clients use the $11,000 annual exclusion ($22,000 for a married couple) to make gifts to younger family members. Shifting assets, and their related income to lower tax brackets is always compelling. The 2003 Act's reduction in rates on ordinary income, dividends, and capital gains will only enhance these income tax benefits when the recipient of your gifts is in a lower bracket than you. We continue to recommend clients take maximum advantage of the $11,000 gifting exclusion.

Making These Changes Work for You

These changes increase the opportunities for our firm to add value on behalf of our clients. Several examples include repositioning REITs to more tax advantageous accounts within one's total asset allocation, reassessing the tradeoffs between 529 accounts and UTMA accounts, revisiting client options with variable annuities (a product we view as "oversold" by brokers due to the generous fees they produce) which lose any appeal they once had under the new tax act. For existing clients our plan is to review these changes (and how they impact you) during upcoming periodic reviews. Those interested in learning more about the benefits of becoming a Trust Company client should call 800-800-9440.

Bond Bomb or Bond Bubble?

Bonds have enjoyed spectacular returns over the last few years, largely due to price appreciation as the Fed repeatedly lowered interest rates in an effort to stimulate growth. But with prices high and yields near historic lows bond investors should proceed with caution. We've been extremely cautious about bonds for the last 6 months, with a tactical underweighting.

We illustrated this in the Spring edition of The Compass in a chart comparison of the SP 500 dividend yield and the yield on the 10 yr. Treasury. Our belief was stocks were undervalued and bonds overvalued, and since the date of that article (April 11) the S&P 500 is up over 15%.

Indeed, since July 1 bonds have fallen significantly with the 10 yr. yield moving up over 60 basis points. A one percentage point increase (100 bps) in rates would reduce the market value of a 10 yr. Treasury by 8%. This translates into over 18 months of interest payments just to break even. If rates rise by two percentage points the market value of the 10 yr. Treasury falls by 15% requiring nearly 3 years of interest payments to break even.

So while the "smart money" is whispering about deflation, we would advise clients to remain conservative in the fixed income arena and be very cautious about "reaching" for yield.

Finding value in bonds requires more skill than ever before, and requires looking in places most investors simply cannot realistically exploit. Institutional bond managers truly operate on a global level finding targets of opportunity in obscure South American government bonds or in high yield corporate debt.

Actually, the best contrarian indicator may well be the new product the financial services industry is rolling out. The financial product assembly line is driven not by what client's need, but rather what the brokerage community can sell. The maxim in our business is: "Products are sold, planning is bought." The latest flavor of the month is "principal protection" vehicles. Call me cynical, but where were these products three years ago? Moves like this make "opportunistic" a four-letter word.

We welcome your questions and comments.

-Mike Palmer, CFP®

Why The Financial Press Is Your Enemy

I remember with painful clarity the scene in April 2000. I was vacationing at a coastal resort and had retreated to the resort's gym for a brief workout. CNBC blared as dozens of guests divided their time between treadmills and tech stocks. I remember chuckling to myself upon overhearing some of the 'expert" comments from those in attendance. I only hope they didn't believe the stuff they were saying, much less act on it.

The more time I spend in the business of personal finance the more convinced I become that most investors need to be protected from themselves. And while corporate executives and investment bankers certainly deserve their share of the blame for the painful side effects of "irrational exuberance" no one ever seems to shine the light on the Fourth Estate. But then again, Dennis Kozlowski and Bernie Ebbers weren't exactly falling over themselves to tell their directors things were rotten in Denmark now were they?

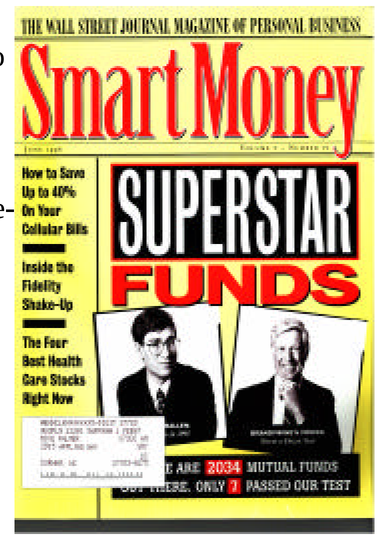
19th Century British historian Carlyle is attributed to coining the phrase Fourth Estate. His observation was that in addition to the three existing estates (as they were conceived of at the time): priesthood, aristocracy and commons, a fourth was springing forth, the media. With the proliferation of newspapers, radio, television and the internet no one can dispute the powerful force now exerted by the mass media.

So it comes as no surprise that the media is reluctant to find fault with itself in contributing to the herd mentality. After all, the press is a for-profit enterprise, and the profits are achieved through increased readership or viewership. What sells? Whatever's hot. And what's hot is usually not in the best interest of the investor. The evidence suggests the "average" investor (although no one I know considers themselves "average"- we are all children of Lake Woebegone) realizes lower returns by chasing hot stocks and mutual funds.

Several months ago I had lunch with a business writer for a local paper. I commented to him that perhaps it might be worthwhile to include retrospectives on how the paper's "expert" stock pickers had performed in previous selections and also include their performance relative to the index. He was very candid in stating that "few managers can beat the index. Telling people to buy index funds really doesn't sell many papers."

The temptation bombards investors everywhere. I reviewed my collection of financial magazines and found numerous examples. During 1996 SmartMoney magazine published three issues touting mutual funds (see chart). The headlines seductively enticed readers with the notion these picks were the keys to the financial kingdom. Ironically within the span of 7 months 21 different funds fell in and out of favor. The 7 Best Mutual Funds for '96 touted in February were passé by August when the 7 Best New Mutual Funds were trumpeted.

February 1996



June 1996

August 1996

But surely out of the 21 funds the folks at SmartMoney selected most would beat the market, right? After all, if these people can't find the best funds, who can? Of the 21 funds featured only **two** managed to beat the index from the month they were featured through 2002. An equally weighted portfolio with all 21 funds, would have resulted in a cumulative return of -3% versus the S&P 500 return of 51%.

The press perpetuates the mistaken belief that forecasting the future is the key to wealth. Most people want to believe that "experts" can consistently pick stocks that will go up, with the same degree of accuracy that a weather forecaster can consistently predict tomorrow's rain. Unfortunately, weather forecasting is far more precise than stock picking. "The Market" is an incredibly efficient machine, capable of synthesizing far more information with greater speed than even the fastest supercomputer. We believe over the long-term efforts to "out-smart" the market are difficult and more often than not result in lower returns.

Quote of the Quarter

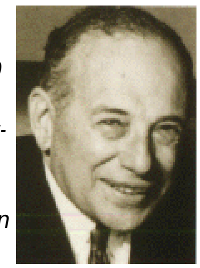
"I don't see anything in the settlement that will concern the retail investor about Morgan Stanley. Not one thing."

Philip J. Purcell, Chairman Morgan Stanley on settlement reached with New York State attorney general Eliot Spitzer. Morgan Stanley agreed to pay $125 million in penalties and admitted to "engaging in acts and practices that created "conflicts of interest" for its clients."

Investor IQ

Take our Summer Investor Quiz. If you can correctly identify the person below you'll be eligible for a drawing for a $50 gift certificate to the Angus Barn. The first 20 correct respondents will be entered into our drawing. Please email your guess to: mpalmer@tcts.com

Do you know me? I was born in 1894 and worked in the brokerage business for over 30 years during which I earned the nickname "The Dean of Wall Street." However, my greatest fame came as a result of teaching at Columbia Business School where many of my pupils went on to achieve fame and fortune in the investment business.



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