THE TRUST COMPANY OF THE SOUTH

The Compass

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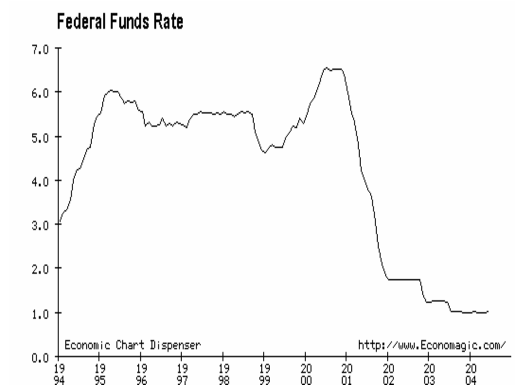
What Comes Down Must Go Up

The Immutable Laws of Bond Physics

Inside this Issue:

In late June the Federal Reserve raised the federal funds rate by 25 basis points to 1.25%, the first increase in nearly four years. The bond markets promptly reversed course and yields on the 10-year Treasury bond fell. These events confuse investors and contribute to false assumptions about fixed income investing.



For some time we've espoused caution as it pertains to fixed income investing. For investors, dealing with uncertainty is a given. But as advisors, identifying the potential outcomes and sorting through all the variables are huge challenges. Being able to predict the future accurately on a consistent basis is not imperative to investment success. **No one, ourselves included, is able to accurately and consistently predict the future. We often remind clients forecasting is for weathermen, not investment managers.**

This doesn't stop many amateur and professional investors from articulating scenarios with the clarity and conviction that could only come from a crystal ball. They carefully articulate a well-reasoned set of arguments that supports their position, while not mentioning the numerous and also compelling counter-arguments. It is not surprising that they are often wrong.

Our efforts are focused on evaluating asset classes and invest in ways that put the odds of success on your side.

An example of our assessment of the risk/return trade-off as it pertains to fixed income investing follows. In short, we strive to quantify how much risk exists within bond portfolios and to determine if the magnitude of risk requires immediate action.

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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Laws of Bond Physics (con't)

We "stress test" hypothetical bond portfolios to gauge how much value one might lose should interest rates rise by 50-100 basis points. Table 1 shows the expected total return for US Treasury bonds of various maturities over a one-year time frame.

We also examined how different *types* of bond portfolios fared in 1994 when the Fed increased short term rates *six* times. The results are illustrated in Table 2.

Bonds are both a source of current income and a low correlating asset when combined with equity assets in a diversified portfolio. Our primary fixed income strategy during this period is to shorten both duration and maturities of our fixed income portfolios.

Table 1 - US Treasury Bonds

			Interest Rate Shock	
Maturity	Yield	Duration	0.50%	1.00%
2	1.60%	1.9	0.66%	-0.27%
3	2.14%	2.9	0.72%	-0.67%
5	2.97%	4.6	0.71%	-1.50%
7	3.49%	5.9	0.58%	-2.23%
10	4.01%	8.1	0.03%	-3.77%

Table 2 - Bond Class Returns

Bond Category	1994
ML 1-3 Yr Treasuries	0.57%
ML 1-10 Yr Treasuries	-1.70%
LB US Gov't/Credit Intermediate	-1.93%
LB US Aggregate Bond Index	-2.92%
ML High Yield (BB)	-2.16%
ML 1-3 Yr Munis	1.31%
ML 3-7 Yr Munis	-1.72%
ML 7-12 Yr Munis	-3.59%

The State of the Financial Union

Two recent surveys provide interesting insight into the state of the financial services profession. Smith Barney recently completed its annual survey of affluent investors. Over 1200 investors with household wealth in excess of $1 million were surveyed in early April. The results were interesting and confirmed many of the points we made in the Spring Compass article *The Emotion of Money*.

- 80% of respondents plan to allocate new money to equities in the coming 12 months. This is versus 60% a year ago. **This affirms our contention that a majority of investors *follow* the market as opposed to *investing* in it.**
- 75% have a brokerage relationship, but 53% do not view themselves as having an *advisor*. **This affirms our contention that there is a significant difference between a broker (non-fiduciary) and an advisor (fiduciary) with comprehensive financial planning expertise!**
- 50% of respondents work under a commission-only relationship. Nearly 1/3 were unsure of how much they paid for commissions/advice during the last 12 months.
- The average annual return expectation for the stock market was 20%, almost exactly the trailing 12 month return. **People take their cues from recent performance, not a favorable method for success.**

A Forrester Research survey of brokerage, bank, and insurance customers illustrates why independent and objective fee-only financial planning firms are increasingly appealing. The study found:

- Only 33% of respondents thought their firm would send them elsewhere if it didn't have the best product.
- 52% felt their provider lacked strong ethics and integrity.
- The most desired attributes in an advisor were objectivity and simplification of their financial lives.

We believe our consultative, fee-only approach to wealth management is appealing to affluent people who want a trusted and experienced financial partner.

If you have friends or family who can benefit from our services, please let us know. Client referrals help us grow our firm, allowing us to attract talented professionals whose skill and expertise benefit all clients.

How Good Is Your Long-Term Care Policy?

It's no secret the Baby Boomer generation is rapidly approaching "seasoned" citizen status. Medical and pharmacology advancements have not only increased life expectancy, but quality of life as well. In 2000, 13% of the US population was over 65; by 2025 it's expected that seniors will comprise 20% of the population.

It is easy to understand the appeal of long-term care insurance, especially since many boomers find themselves caring for elderly parents. Interestingly, many big name insurance companies have exited the long-term care market over the last year, including AEGON, TIAA-CREF, and CNA.

Most individuals buy long-term care coverage with the idea that it will provide **in-home** assisted care when they are no longer able to fully care for themselves. While this benefit is available with some policies, purchasers must be vigilant in making sure they understand the benefits and eligibility requirements of the policy. "A policy may pay for a licensed assisted-living facility," says Bernard Krooks, an elder care lawyer, "but that's not the same thing as an adult home for which an outside agency provides licensed care."

Policy owners can also expect premium increases in coming years. Even though LTC premiums are "guaranteed," insurers can raise rates for the entire class of policyholders if claims exceed expectations—which is very likely. Although LTC coverage has been around over 20 years, insurers have had very limited claims experience. "Actuaries used life insurance lapse rates of 10 percent 20 years ago, but lapse rates on long-term care have been running 2 percent," according to Brian Peterson at TIAA-CREF.

Assessing long-term care coverage or determining whether you or a family member needs coverage is a difficult task. Since we don't sell LTC insurance, we are uniquely positioned to provide independent and objective evaluations and assess policies for our clients to help them secure appropriate coverage.

- Mike Palmer, CFP®

How We Add Value– A Case Study

One of our valued clients, Ms. Sally Earnest of Fearrington Village, became a grandmother for the first time in June. During a meeting in January, Sally told us she would like to start a college savings fund for her expectant grandchild. She asked our guidance on how to do so most effectively.

There are several educational funding options available, most notably 529 plans and Coverdell plans. Since the child's parents live in Colorado, we researched whether that state offered any 529 benefits. Indeed, Colorado offers a state income tax deduction for contributions to the state's 529 plan.

We recommended Sally gift funds to her son and allow him to establish the 529. Our solution created a win-win-win!

Young Wyatt Andrews Earnest (6 lbs. 5 oz.) gets a head start on saving for his college education; Sally's son ,Scott, gets a state income tax deduction; and Sally gets the immeasurable satisfaction of knowing she is helping her grandson on the road to lifelong learning. Sally's legacy is likely to impact the Earnest family for generations to come.

We take great pride in the fact our clients look to us as their financial advocate—providing clarity and answers regardless of how complex or straightforward the subject.

Quote of the Quarter

"There are many, many good people who have gone to prison. Look at Nelson Mandela."

- Martha Stewart, following her sentencing to five months in prison and five months of house arrest. *Editorial comment: You can't make this stuff up.*

TCTS STAFF UPDATE

We've been pleased to have Jill Johnson and Doug Vestal as summer interns with the firm. Jill will graduate next Spring with a Trust Management and MBA from Campbell University. Doug will graduate in May from NC State with a masters in mathematics. Please join us in wishing them much success!

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