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summer 2005

THIS ISSUE...

Remember the AMT!

by John Slayton, CFP®

I would be the last person to suggest that the Alternative Minimum Tax (AMT) has an Alamo-like impact on the unsuspecting taxpayer, but it does bear consideration. The AMT was originally enacted in 1969 in reaction to stories that some very wealthy people were using deductions to avoid paying much, if any, taxes. Like so many other regulatory cures of perceived inequities, the AMT has developed into a large gauge shotgun, rather than a sharp scalpel. The AMT was never indexed for inflation, and now many middle-income earners, particularly with large families living in high-tax states, are subject to it. In 1999, approximately 1 million taxpayers were subject to AMT. In 2003, 2.3 million taxpayers paid AMT, growing to an estimated 19 million taxpayers in 2006 and perhaps as high as 36 million by 2010.

Basically, taxpayers do two parallel tax calculations and pay the higher result. AMT planning is growing more and more complex. Timing of the payment of large itemized deductions that are not deductible for AMT and bunching of income into years in which the deductions are smaller are two ways to limit AMT. Timing of exercise of incentive stock options is very complex. The difficulty is that you cannot simply project one year and draw a conclusion. Multiple years and scenarios are needed for planning. If a taxpayer does pay AMT and a minimum tax credit is generated, another level of complexity is layered on top of the situation and additional planning is required. NOT FOR THE FAINT OF HEART !!

A temporary relief, increasing the AMT exemption for joint filers from $49,000 to $58,000 ($40,500 for single filers), was in place only for 2003 and 2004. The good news [which we always strive to present] is that legislation to repeal the AMT was introduced by a bi-partisan coalition of Senate finance committee members in May. The bad news is that it is estimated that through 2010, it would cost more than $600 billion to repeal the AMT. How AMT repeal prioritizes with repeal of the estate tax, social security reform, and out-of-control budget deficits is a matter for serious consideration by our learned elected officials. In the interim, let us know if we can assist you in planning.

NOTABLE QUOTE

"Stock certificates are deeds of ownership, not betting slips. There are no safeguards that can protect the emotional investor from himself."

J. Paul Getty

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

Market Commentary

by Mike Palmer, CFP®

One of the great joys and challenges of my contributions at Trust Company involves research and reading. The joy is that I thoroughly enjoy reading, with the challenge being that there never is quite enough time to read all that I would like. My reading this quarter uncovered two interesting themes of importance to investors – the active versus passive portfolio management debate and the danger investors face in projecting "average" returns into the future.

I was bemused by recent commentaries that deride passive management as "settling for average" and observe that investors in low-cost index funds "get what they pay for." The facts, according to Standard & Poor's, indicate more investors could benefit from capturing the market returns that are there for the taking. For the five years ending March 31, 2005, S&P found that only 38% of large-cap funds surpassed the S&P 500, only 19% of mid-cap funds topped the S&P MidCap 400, and only 26% of small-cap funds beat the S&P SmallCap 600.[1] It is difficult for an objective advisor to ignore these facts.

The contention often made by active managers is their ability to "outperform" in down markets. The evidence from S&P (and backed by various other studies over the years) clearly indicates otherwise. For the five years ending March 31, 2005, the S&P 500 lost 3.16% annualized. This period includes the 2000-2002 decline, during which the index posted annual returns of –9%, -12% and -22% respectively. Surely such adverse conditions provide the ideal setting for active managers to show their mettle, right? Alas, the facts indicate only 1 of 3 managers beat the market during this period. As objective fiduciaries, we are not beholden to our own proprietary investment strategy. Our mission is to analyze capital market research and find investments that give our clients the greatest probability of success. Unlike some advisors offering only proprietary investment management, when we find a better mousetrap, we aren't conflicted about using it.

We don't expect to convince market "seers" or active fund managers of the advantages of passive asset management. However, *investors* would be wise to ignore the hype of "investment pornography" touting 5-star rated funds and the tendency to view past performance as an indicator of future results (fans of Morningstar should read Matthew Morey's study *The Kiss of Death: A 5-Star Morningstar Fund Rating)*. A review of the 3rd Restatement of Trusts, the Uniform Prudent Investor Act, and the collective academic research provides a compelling case for the inclusion of passive investments in a portfolio.

I always delight in reading Warren Buffett's annual letter to shareholders of Berkshire Hathaway. Despite his legendary status as the preeminent investor of our time, even Buffett himself contends index investing is a sound strategy.[2] But more elucidating is Buffett's keen eye on the dispersion of annual returns produced by the S&P 500 over the last 35 years (see chart A).

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	AMY	STEVE	BOB
Year 1	5%	0%	-5%
Year 2	10%	0%	8%
Year 3	12%	27%	40%
Arithmetic Average Return	9%	9%	9%
Compound Annual Return	8.96%	8.29%	6.96%

CHART B

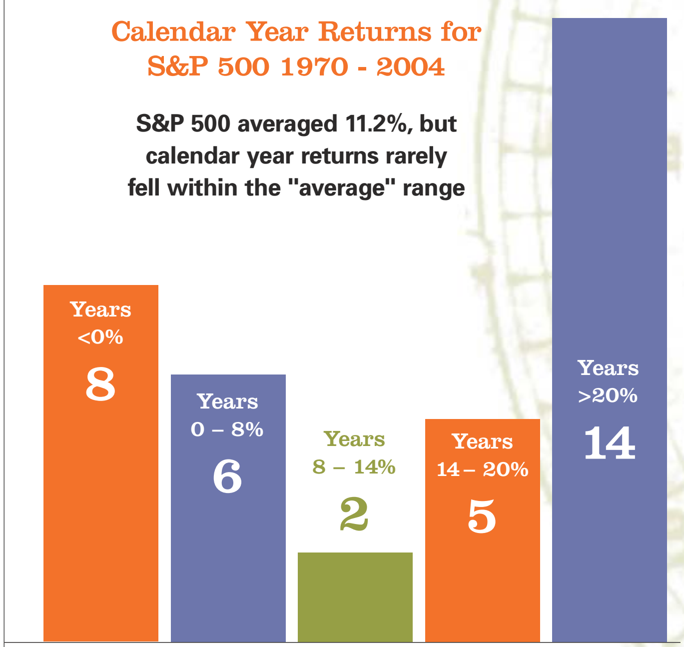


CHART A

[1] *SPIVA April 2005*

[2] *Berkshire Hathaway 2004 Letter to Shareholders*

How We Add Value

by Mike Palmer, CFP®

During a recent client meeting I asked a client, whom I'll call Margie, about any concerns she had regarding wealth transfer to her adult children. Our firm has relationships with three generations of the family, having only recently commenced a relationship with the matriarch of the family, who is in her 80s. My discussion with Margie uncovered concern about one daughter, Alison, who's suffered from chemical dependency on and off over the years. Margie noted that she and her husband would leave their assets in trust for Alison. "What about your mother?" I asked. The mother was the beneficiary of a sizable by-pass trust. Upon her death the trust terminates with 50% going to Margie and 50% split equally between Margie's two children.

Our review of the trust uncovered a limited power of appointment (POA) provision. The POA, if properly exercised, enables Margie's mother to direct in her will that Alison's share be retained in trust. Interestingly, several months earlier Margie had amended her estate plan, but with no discussion of her mother's estate plan or how her mother's assets (including any trusts) might best be protected. As a result of our review and Margie's desire to protect wealth for her daughter, Margie's mother amended her will to extend the desired protection of the trust assets for Alison.

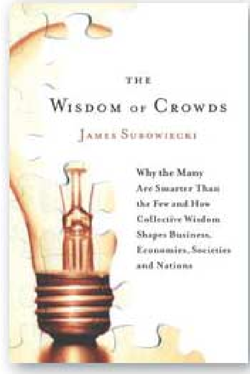
We view the financial planning element we deliver to our clients as a thread that binds the fabric of their wealth together, providing financial peace of mind. Financial planning acumen isn't something that appears in our fee schedule or in our investment portfolios, but for our clients, there is no mistaking its value.

Market Commentary continued

There are two important lessons here: (1) the much ballyhooed "average" equity return so frequently quoted by financial advisors rarely occurs in any given year. To the contrary, the statistics indicate the trip to Investment Nirvana is one with many peaks and valleys. This historical fact makes investment discipline critical to achieving a successful investment experience. (2) few investors (or advisors) understand the difference between an *arithmetic* average return and a *geometric* average return. The **sequence** of one's investment returns has significant impact on one's portfolio (see chart B).

We take great care in helping you achieve a successful investment experience. Both active and passive investing styles have merit. As objective advisors, we often recommend an active/passive investment strategy as a means to reduce the risk of using exclusively active management. Our core/satellite approach, combined with discipline, managing emotion and an adherence to multiple asset class investing and Monte Carlo simulations provide us with the tools to achieve financial serenity for our clients.

BOOK REVIEW



The Wisdom of Crowds:

Why the Many Are Smarter than the Few and How Collective Wisdom Shapes Business, Economies, Societies, and Nations

H.L. Mencken once noted that no one ever lost money underestimating the intelligence of the masses. Author James Surowiecki contends Mencken had it wrong – that under the right circumstances, groups are remarkably intelligent and are often smarter than the smartest member of a group. *The Wisdom of Crowds* offers interesting insight into how collective decision-making can work and what causes it to break down.

Surowiecki contends problems can be categorized as either cognition, coordination, or cooperation problems. Regardless of the type of problem, three critical ingredients are necessary to allow collective wisdom to work: diversity, independence, and decentralization.

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Behind the Scenes at Trust Company of the South

>> In May, **Mike Palmer** attended the National Association of Personal Financial Advisors national conference in Tampa.

>> **John Slayton** authored an article in the summer issue of *Carolina Banker* magazine on the changing responsibilities of corporate trustees.

>> **Mike Palmer** and **John Slayton** will be attending the NC Bar Association's Estate Planning and Fiduciary Law Program in July.

>> We are pleased to welcome **Catie Iber** to the firm as Operations Officer. She is a graduate of Furman University with a degree in accounting and will work in our Burlington office.

>> We recommend reading Roger Lowenstein's article "What Went Wrong at GM" in the July issue of *SmartMoney*. It is a cautionary tale of the coming Medicare maelstrom.

>> **Mike Palmer** was quoted in the June 20th issue of *Investment News* on standards for financial planning.

>> **Linda Paul** has been promoted to Client Services Manager. Linda has long been a "go-to" person within our firm and will continue much of her direct work with clients. In addition, her new responsibilities will provide valuable leadership for our administrative staff. Please join us in congratulating Linda on her new position!

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BOOK REVIEW, *cont'd*

The book offers numerous examples of collective wisdom. In May 1968, the U.S. submarine Scorpion disappeared while returning to port. The navy knew only the sub's last reported location and no idea what had happened to the ship. Naval officer John Craven assembled a team with a wide range of specialities including mathematicians, naval experts, and salvage men. Rather than having them consult with each other, he had each to come up with a hypothesis of what had happened to the *Scorpion*. Craven then aggregated all the guesses, using a formula known as Bayes theorem. Five months after the disappearance, the navy found the *Scorpion* – 220 yards from where Craven's analysis had predicted it would be.

Perhaps the most successful example of collective wisdom in action is the Internet search engine Google. Google uses a Page Rank algorithm that essentially aggregates all previous searches and weights "successful" searches (as noted by click throughs) more heavily. Test this with any arcane search and it is amazingly successful. I entered "Bill Buckner's rookie year in majors" into a Google search and .12 seconds later the top ranked page was baseballlibrary.com's page for Buckner that listed his rookie year in the big leagues as 1971.

***The Wisdom of Crowds* captures the reader's attention and is a thought-proving book that helps make more sense of our everyday world. It covers a diverse range of topics from investing to entertainment to politics. If you are looking for an interesting book to take along on vacation, you'll enjoy *The Wisdom of Crowds*.**