
[the*compass*] winter 2012

THIS ISSUE...



# Living the Miller High Life?

## An Investor's Journey With Legg Mason's Bill Miller

by Mike Palmer, CFP®

I share an interesting, albeit relatively obscure, connection with Bill Miller, the heralded fund manager of Legg Mason Value Trust. In 1991 I commenced my career as a financial advisor at First Union National Bank. That same year Mr. Miller started an unequaled streak of 15 consecutive years of beating the S&P 500 index. Miller, who announced his retirement effective next April, is widely regarded as the most successful fund manager of his era.

Yet Mr. Miller's impressive performance record provides an interesting case study in whether past performance is a good basis upon which to select an investment manager. Many investors (and many investment consultants) place great significance on past performance as a key measure of manager selection. The data suggests this emphasis may well be misguided.

From the start of his streak in 1991 through the end of 1997 (a seven year period), Miller's fund produced an eye-popping 24% annualized return versus a mere 19.6% for the S&P 500 index. For investors or consultants using 5 or 7 year performance screens to select funds, Legg Mason Value Trust looked like a good bet. Beating the benchmark for three years is often considered quite a coup, so surely someone capable of seven years of superior performance has slipped the surly bonds of luck and touched the mantle of skill.

Unlike what so often happens with hot fund managers, Bill Miller was able to extend

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### NOTABLE QUOTE

**"The major problem with trying to quantify 'risk tolerance' is that it erases the critical distinction between volatility and risk; or if you prefer, between temporary decline and permanent loss."**

– Nick Murray


# ‘Tis Better To Give Than To Receive …

by John Slayton, CFP®

As many folks review their gifting plans for the coming year, it is always good to consider the most effective way to make gifts. We routinely address this strong financial planning tool with clients, even though they sometimes feel we have been co-opted by their children into encouraging generous gifting. These benefits are magnified greatly with today’s low interest rate regime. If you have ever considered gifting to reduce estate taxes, the time to act is now!

## What impact do today’s low interest rates have on gifting strategies?

- **Intra-family loans** can be made at historically low rates of 0.20% for one year, 1.27% up to ten years and 2.8% over 10 years (at December’s rates). You can benefit your children and charge them next to nothing in terms of interest. We call this a “no-brainer” in our business.

- In split interest gifts, such as *grantor retained annuity trusts (GRATs) or gifts to charity of remainder interests in personal residences,* the lower the assumed interest rate, the less a retained income interest is worth and the more the remainder income interest is worth, because it is discounted less. An annuity stream must be discounted for lost time value of money for deferred payments.

- The section 7520 rate (120% of the mid-term applicable federal rate) is used to discount future income streams. The October and November rates of 1.4% were the lowest in history. December’s rate increased to 1.6%, so the trend is increasing.

- Preferred use of a GRAT “zeroes-out” the gift portion (the remainder interest), resulting in the transfer of value to your beneficiaries with no gift tax due. The lower the section 7520 rate, the smaller the annuity you need to retain to produce zero gift tax. For instance, at an 8% section 7520 rate, the annual annuity payment to the grantor needed to zero out a 10-year $1 million GRAT is $149,029, while at a 1.4% section 7520 rate, the amount needed to zero out the same GRAT is $107,861 (only slightly larger than the return of one-tenth of the principal annually with no discount). This should leave significantly

## Non-Profit Spotlight: YMCA of the Triangle

by Mike Palmer, CFP®

**Over the summer I had the privilege of serving as a judge for a business apprentice workshop conducted by Camp High Hopes, a summer camp serving over 800 kids at St. Augustine’s College through the YMCA of the Triangle. The apprentice competition for middle school age kids encouraged teamwork, spurred creativity and challenged them to think like entrepreneurs. Business executive and YMCA board member John Healy believes the YMCA mission makes a powerful difference in the lives of young people. According to Healy, “the Y’s focus on mentorship and life skills isn’t necessarily unique, but the family-like commitment from the Y staff is unequaled in my experience. There’s an authenticity to the staff’s efforts that is evident in everything they do.” If you would like to support the YMCA of the Triangle please contact Ms. Sims McCorkle at 919-719-9622.**

more assets passing to your beneficiaries at the end of the 10 year term, while maintaining no gift tax.

### What can I gift annually without incurring gift tax?

Each year you can gift $13,000 ($26,000 per couple) to anyone without paying gift tax. Cash is always appropriate to gift, but if you give assets with depressed values (quite common today) you will also have the advantage of transferring any future appreciation tax free.

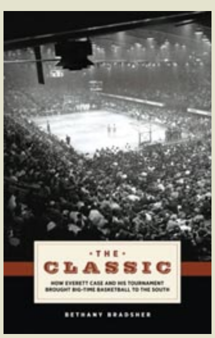
### What can I gift over my lifetime or at my death without incurring gift tax?

In 2011 the lifetime exemption from gift and estate taxes was increased to $5 million and $5.12 million in 2012, with an estate and gift tax rate of 35% above this exemption. Without further congressional action, the lifetime exemption amount is set to drop to $1 million in 2013 and the tax rate is scheduled to increase to 55%.

### What tax-efficient tools could I use for gifting this year to take advantage of the $5.12 million exemption before it decreases?

- **Qualified Personal Residence Trust ("QPRT")** – where you transfer your residence into a QPRT for your heirs while retaining the right to live in your residence for a term of years. The initial transfer of the residence to the QPRT (this year) is a gift to the remainder beneficiaries that is valued based on the remainder interest in the property. While the current low interest rates increase the remainder value to the beneficiaries, the combination of today's depressed asset values and the high exemption make this a desirable tactic.
- **Irrevocable Life Insurance Trusts ("ILITs")** – either new life insurance policies can be obtained by, or old policies assigned to, an ILIT for the benefit of your children. Annual gifts to the ILIT fund premium payments, allowing you to maintain a large insurance coverage outside of your estate.
- **Transfer of Family Business** – start giving minority interests in the family business today and use the large exemption before it expires. This also takes future appreciation out of your estate when your family business balloons in value.

Clearly, now is the time to consider gifting. Low interest rates and asset values, coupled with high and expiring exemptions, call for large gifts in the short term. Always remember that, during life and at death, your assets either go to the people or charities you desire to support, or the government. You can direct them to the destination you choose, but you cannot take them with you.




### TCTS Book Discussion

**Thursday, March 1, 2012 11:45 am – 1 pm**

**We'd like to invite friends of our firm and their guests to a lunch and book discussion on Thursday March 1 in the Raleigh office. We hope to make this a recurring event. Our initial luncheon will feature Bethany Bradsher's book, *The Classic: A History of the Dixie Classic.* This is an easy read of the history of NC State's coach Everett Case's efforts to bring big-time basketball to Tobacco Road. We'll be joined by former Dixie Classic players Lou Pucillo and Jackie Murdock for an entertaining discussion. Please call Lisa Shirley to reserve a space, 919-781-8287.**

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his win streak for eight more years, a phenomenal accomplishment. But then performance stalled. For the years after his winning streak ended in 2005, investors experienced an annualized return of -7.4%.

The investor buying Mr. Miller's fund in 1998 after the seven year run, and holding it through November 2011, got a real life lesson in reversion to the mean. Miller's fund returned 2.2% annualized versus 3.5% for the S&P 500 during this period.

We often compete with advisors and consultants with sophisticated stories of manager selection and due diligence. Impressive graphs and eloquent narratives bring a mystic quality to what most describe as the art (dark art, perhaps?) of manager selection. It is a quantitative story heavy on Greek letters and statistical formulas few understand. But this story often melts away with a more important and simpler question: How do you decide to fire a money manager?

One of the interesting things about mutual fund performance isn't that the number of managers beating the benchmark for long time periods is so few, but rather that the number is significantly smaller than one would expect to get from simply flipping a coin.

While humans are certainly pattern-seeking animals, when it comes to investing one's money we'd urge caution in relying on using past performance as a selection criteria.

## Behind the Scenes at Trust Company of the South

>> **Mike Palmer** was quoted in the December 6th edition of the Wall Street Journal in an article on life insurance.

>> **John Slayton** has co-authored a college finance textbook, *Information Technology for Global Financial Markets: Emerging Development and Effects.*

>> Zachary Palmer, son of **Mike Palmer**, was recently inducted into the National Honor Society at Broughton High School.

THE TRUST COMPANY OF THE SOUTH


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