
[the*compass*] winter 2005

THIS ISSUE...



# New Year's Resolution: Overcoming "Analysis Paralysis"

**by Mike Palmer, CFP®**

Many of us use the start of a new year to improve something about ourselves. These resolutions run the gamut from improved physical fitness to better spending habits. One financial "vice" we sometimes encounter in prospective clients (and some existing ones) is what I call "analysis paralysis." Sufferers of this malady are usually very intelligent people, professionals or business owners accustomed to success. However, their "analysis paralysis" prevents them from experiencing the same level of success with their investment efforts.

"Analysis paralysis" usually involves either a reluctance to delegate or an inability to accept the risk-return principle — risk and return are related. Let me share two examples. Joe is a 65 year-old retired senior executive. He's highly intelligent and a voracious reader. Joe has managed his own investments and used professional advisors but has been unable to find financial "peace of mind" because he's unwilling to accept asset class returns. His inability to establish a well-designed investment policy and his tendency to be reactive to events have led to inferior investment returns.

Steve is a 45 year-old business executive. His wealth is significantly concentrated in one stock. The stock has done very well, but he's backtracked from selling portions of the stock when it reached previously agreed price targets. He believes the stock will go higher because of Wall Street "buy" ratings or management changes. He's unable to see the risk-return quotient as being skewed. For another 3%-5% gain in the stock, he is assuming five or ten times that amount of risk.

Overcoming "analysis paralysis" isn't easy: it requires discipline and trust. But for those willing to try, the reward is two-fold: (1) a life focused on things that give you the most satisfaction, whether professional success, more time with family and friends, pursuing passions like the arts or hobbies, or civic service and (2) an improved financial plan and investment strategy.

Our most successful clients avoid "analysis paralysis," preferring to delegate the details (after mutual agreement and consultation) of their financial plan to us and take comfort in our investment strategy of not trying to outsmart the market. As one client wrote to me in a Christmas greeting, "…thanks so much for all you do. I know whatever comes up you'll be able to handle it."

## NOTABLE QUOTE

**"We in this country… are — by destiny rather than by choice — the watchmen on the walls of world freedom."**

**President John F. Kennedy, from the speech he was on his way to make when he died November 22, 1963**

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 managing wealth is more than managing money*

# Market Commentary

by Mike Palmer, CFP®

Capital markets enjoyed positive results across the board in 2004. REITs once again led our asset classes with returns of 31% for the NAREIT Equity Index. Bonds produced the most modest returns of any of our asset classes with the Lehman Brothers Aggregate Bond Index, producing a 4% return for the year. Overall, our investment portfolios enjoyed superior risk-adjusted results in 2004, a tribute to our multiple asset class investment discipline.

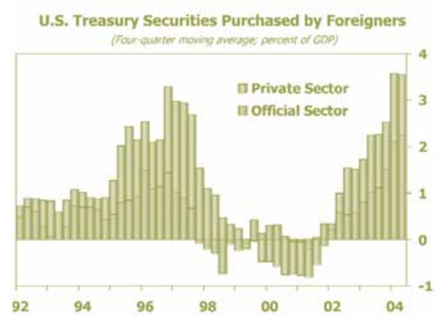
Despite the temptation and the seemingly endless need by Wall Street pundits to forecast the future, we do not engage in this exercise. The capital


markets, like the weather, tend to humble those that profess to know the future. Our task is to manage risk by evaluating and analyzing asset class valuations and identifying favorable investment strategies.

We've reduced our allocation to high-yield bonds, which, given their low spreads over investment-grade bonds, do not offer favorable risk-return characteristics. We've been researching two new asset classes or sub-classes — floating rate debt and commodities. Our analysis of these investment strategies is based on our concern about the interest rate outlook. Two factors make us increasingly concerned about inflation and interest rates: the on-going situation in Iraq (and its cost) and the declining dollar. The cost of the Iraq occupation is north of $200 billion with no end in sight. Whether described as a "war," "military action," or "occupation," the fact remains that every US military conflict since WWI has ultimately resulted in rising inflation. Given the low levels we're starting from, some moderate increase in inflation and interest rates seems almost inevitable.

The dollar has declined materially already (nearly 25% versus the Euro), with the "experts" divided on a near-term correction or a longer term decline. A declining dollar could mean higher interest rates are required to attract the capital to fund our current account deficit. We prefer to be cautious in the fixed income area given these dynamics.

Bonds' most important role in our portfolios is as a volatility dampener. Given current low yields, big returns from bonds would require a meaningful drop in interest rates, which we view as unlikely since the Fed has clearly stated it is in a slow-and-steady tightening mode. And with a massive budget deficit, bond supply is likely to increase, which should also put some upward pressure on rates. Foreign governments, particularly in Asia, have been huge buyers of Treasuries in recent years, but at some point their willingness to add to their Treasury positions will wane, and the resulting reduction in demand could also lead to higher rates.




Commodities and floating rate debt are hedges against rising inflation and interest rates, respectively. Commodities have received a great deal of attention thanks to their strong performance in recent years. We've done extensive research getting our hands around this asset class. Commodities' long-term return and lack of correlation to equities offer appeal from a portfolio-construction standpoint. However, commodities are exponentially more volatile, even month to month, challenging even the most steadfast investor.

Floating rate debt is appealing, especially in a rising interest rate environment. We're close to making decisions on this asset class and expect to make changes to incorporate this as a percentage of the fixed income allocation in the coming weeks.

We continue to work diligently on building multiple-asset class portfolios, accepting asset class returns and minimizing risk. This philosophy, combined with our focus on managing client emotion every bit as much as managing client wealth, should produce long-term rewards.

# Investment Focus: DFA Large Cap Value

by Mike Palmer, CFP®

For many of our clients, large capitalization stocks are the foundation (and largest asset class holding) of their investment portfolios. Large cap stocks, generally speaking, have market capitalization (price per share multiplied by number of shares outstanding) in excess of $10 billion.

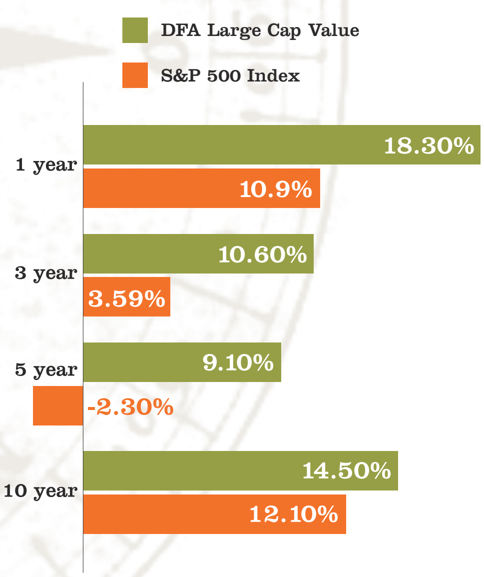
Dimensional Fund Advisors (DFA) is a $50 billion investment firm whose investment style exploits efficient capital markets and rigorous academic research. The data on market efficiency is difficult to refute. According to Standard & Poor's, only 3 of 10 large cap funds managed to beat the S&P 500 index for the 3 years ending September 30, 2004. When one adjusts returns for survivorship bias (returns of funds closed or mergered out of existence are not included) the case for DFA's approach becomes even more compelling.

DFA employs a three-factor model to create engineered asset class funds. We've used DFA Large Cap Value in client portfolios for several years and believe it has several appealing characteristics.

>> **Expenses:** Whether in the form of sales loads or internal costs, expenses are a significant drag on returns. DFA Large Cap Value has a very low expense ratio of 31 basis points.

>> **Diversification:** DFA Large Cap Value is extremely well diversified, with over 220 holdings across all industry sectors.

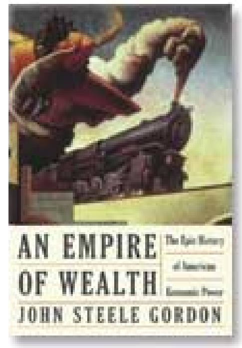
>> **Superior risk-adjusted returns:** The fund has produced annualized returns of 18.2%, 10.6% and 9.1% over the last 1, 3 and 5 years ending December 31, 2004, versus S&P 500 returns of 10.7%, 3.5% and -2.3% for the same period.




In summary, we think the large cap equity asset class is a fundamental building block of every investment portfolio, and DFA Large Cap Value provides our clients with an excellent core holding. We expect this fund will continue to lower portfolio risk and deliver superior absolute returns.

*For more information about this fund, please contact our office to request a prospectus. Past performance is no guarantee of future results.*

BOOK REVIEW




## An Empire of Wealth: The Epic History of American Economic Power

**As Winston Churchill so profoundly stated nearly a century ago, "… those who do not study history are bound to repeat it." For investors, an understanding of United States economic history is essential to understanding the fundamentals of our economic system and capital markets.**

**Author John Steele Gordon, whose other notable works include *The Great Game* and *A Thread Across the Ocean,* delivers a remarkable book that documents the development of the US economy from colonial times to present day. The evolution of the United States as the greatest economic power the world has ever known is a fascinating story full of resplendent figures combined with elements of serendipity.**

**Gordon eloquently describes the iconic moments in our economic history and puts them in political and social context. His inclusion of often arcane**

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# Behind the Scenes at Trust Company of the South

>> **Bill Noble** and **John Slayton** attended the Duke Estate Planning Conference in October.

>> In November, **Mike Palmer** attended the NAPFA South Region Conference in Orlando.

>> **John Slayton** is chairing the Legislative Committee of the North Carolina Bar Association's Estate Planning & Fiduciary Law Section. The Committee spearheads the Section's legislative efforts.

>> **Amanda Crumpton** joined Trust Company of the South in October as Client Services Officer. Amanda is a native of Alamance County and attended East Carolina University. She is based in our Burlington office. Please join us in welcoming Amanda to the firm.

>> We are pleased to announce **Jill Johnson,** our 2004 summer intern, has accepted a position as Client Services Officer upon her graduation from Campbell University in May. Jill will graduate with an MBA with a trust management concentration. She'll be based in our Raleigh office.

>> In October, **Bill Noble** attended the NC Center for Non-Profits annual conference in Raleigh.

>> **Mike Palmer** was quoted in the November issue of *Investment Advisor* magazine on fiduciary standard of care.

>> **Trust Company of the South** participated in a half day training session conducted by **TIAA-CREF Advisor Services Group**. Our firm is approved to work directly with TIAA-CREF Advisor Services on behalf of TIAA-CREF participants.

>> **Mike Palmer** attended the Triangle Community Foundation's presentation featuring Janne Gallagher, General Counsel of the Council on Foundations.

>> **Bill Smith** has been appointed to the Board of Directors of the Charitable Foundation of Alamance Regional Medical Center.

>> **Mike Palmer** attended the Intersouth Partners annual meeting in December.

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## BOOK REVIEW, *cont'd*

anecdotes makes it an entertaining read. I found especially fascinating the history of The Bank of Manhattan, created in 1799 by Aaron Burr. Its charter was initially granted under the guise of providing water to New York City. The Bank of Manhattan eventually became J.P. Morgan Chase. An interesting irony is that the bank's namesake, J.P. Morgan, was born in 1836, the year America's second central bank dissolved. He died in 1913, the same year the Federal Reserve System came into being. Twice during his illustrious career, in 1895 and 1907, Morgan virtually single-handedly served as the country's central banker to avert economic collapse.

Libertarians will enjoy learning the quixotic evolution of the income tax. In 1895, the Supreme Court ruled the income tax enacted the previous year was unconstitutional (Pollack v. Farmers' Loan and Trust). The income tax was later enacted by constitutional amendment, an idea proposed by a Republican President (William Howard Taft in 1909). The Sixteenth Amendment ratifying the income tax became law in 1913.

***An Empire of Wealth*** is a book I'd love to see as a Ken Burns documentary. I think you'll find it an enjoyable and captivating adventure through American economic history.