[the*compass*]

winter 2006

THIS ISSUE...

Don't Confuse Financial "Porn" with Financial Wisdom

by Bill Noble

Every time I walk by a magazine stand or turn on CNBC, I'm amazed by the urgent and alarmist headlines exclaiming the latest economic Armageddon or the hottest stock or mutual fund that investors *must* buy in order to achieve financial fulfillment. The constant barrage of dazzling headlines and investment news programs falls under the category of what we call "noise" -- or even better, "financial pornography."

"Financial pornography" is a term I borrow from a number of financial planning and investment experts. It refers to how the mass media attempts to capture readers or viewers. "Dare to be dull" is not a headline that is likely to get someone "hot and bothered," even though it is likely to be a recipe for financial success. The fact of the matter is the media are focused on their profitability, not yours!

Noted author Dan Wheeler said it best:

"The financial press has probably done as much damage to investors' wealth as any mutual fund scandal or underhanded corporate executive by encouraging investors to constantly move their money in and out of the markets and fueling the twin emotional motivators of greed and fear."

Here are just a few examples that Jonathan Chevreau of the *National Post* recently cited as classic examples of "Financial Pornography" from over the past twenty years:

>> For three successive annual issues, *Smart Money* magazine ran a feature article called "7 Best Mutual Funds," beginning in 1996. If you rushed out to buy all seven, you would have lost 6.7% that year. In 1997, it chose seven brand new funds, which then sank 3.4%. In 1998, it picked just six funds, resulting in a marginal improvement: the six funds together lost only 2.2%.

>> In 1999, an anonymous *Fortune* writer spilled the beans when he/she wrote "Confessions of a former mutual funds reporter." "By day we write 'Six Funds to Buy NOW!' By night, we invest in sensible index funds." (You can find it archived at www.bylo.org.)

continued back cover

NOTABLE QUOTE

"The unexpected happens. You had better be prepared for it."

Margaret Thatcher

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

Objects in Prospectus Are Smaller Than They Appear

by Mike Palmer, CFP®

We've all been counseled in the adage "If it sounds too good to be true, it probably is." Several years ago I formulated a corollary to that rule which I call Palmer's Law. Palmer's Law states that any financial solicitation that promotes investment returns requires great circumspection and can't be accepted at face value.

My nearly twenty years in the financial services profession has confirmed one very tried and true belief – *salesmen promote returns, advisors promote solutions.* Case in point: The following is an actual email solicitation that one of our clients received from his insurance agent. The names are removed to protect the innocent (and unfortunately, the guilty).

Dear Clients:

ING is offering an annuity which guarantees you 7% per year at worst and market performance (no cap!) at best.

Presently, ING is offering a 5% bonus on top of the 7% for deposits between $100,000 and $3,000,000. That is 13% guaranteed the first year and 7% thereafter.

This is a 10 year annuity, i.e. this investment is for long-term money. I thought you might have an interest in this. Please call me if you do. This is the best return I can find for "safe" money.

What makes this solicitation especially dangerous is that 7% is a "reasonable" return. {Author's note: this email was copied exactly as it came. I can only attribute the agent's inability to add 7+5 correctly to his zeal in offering this "safe" investment to his clients.}

However, upon closer examination (which requires reading a 170-page prospectus), one discovers that this attractive looking rose has many thorns.

There are limitations one faces in capturing the 7% guarantee, which is known in ING literature as the minimum guaranteed income benefit (MGIB). In order to receive the MGIB, the owner must annuitize the contract. An example may help clarify. Assume Joe Smith, age 69, invests $100,000 in the ING annuity. Further assume that the underlying fund investments within his annuity perform modestly, returning only 6% net of fees (more on fees a bit later). If Joe Smith realized the 7% guaranteed minimum income benefit at the end of 10 years, his annuity would be worth $205,669. But Joe gets this value only if he leaves the money with ING and commences annuitizing the contract!

The reason ING is able to guarantee 7% on the front end is that once the owner commences annuitizing, ING only pays 1.5%. This is known as the crediting rate for the annuitization phase and it is set at the time of purchase, not 10 years hence when Joe actually starts annuitizing his investment.

A review of the ING prospectus and a sharp pencil (actually, a HP10B calculator) offer a more accurate picture of what one might realize from investing in this "safe" investment. If at the end of 10 years, Joe Smith decides to take a 10-year certain annuity payout, his rate of return over the entire 20-year span of the investment would be **3.65%!** As an aside, the average life expectancy for a 69-year-old male is 9 years. Yet Joe comes from healthy stock and lives to the ripe old age of 94. In that event his rate of return over the 25-year span of his investment is 5.52%.

There are many other thorns to this offering, but space limitations preclude providing in-depth analysis. Among them: steep surrender penalties (8% for the first 4 years), high mortality and administration expenses (1%-2% per annum), and mutual fund expenses of 1% to 3% per annum. It is hard to capture the upside of the market when one loses 2% to 5% per year in fees!

The Cobbler's Children Get Shoes
(and a College Education)

by Mike Palmer, CFP®

Everyone is familiar with the story of the cobbler who was so busy working on customers' shoes that he failed to allocate time to make shoes for his own kids. At a recent NAPFA conference, I commiserated with fellow attendees about not having adequate time to spend on my own financial plan, and I returned committed to doing just that.

In fairness, compared to most people I encounter, my financial house is in pretty good order. Our family lives on a budget; the only debt we have is our mortgage. We are adequately insured if something happened to me or my wife, and we have a plan in place to fund a secure retirement. However, I have four children; and while I make monthly contributions to 529 plans for their college education, I hadn't taken the time to "run the numbers" on exactly what it might cost to educate them. I'd fully intended to fund some of the expense out of cash flow; but not knowing how much that might be seemed foolish, so I commenced to "cobble" out exactly how my wife and I planned to pay for our kids' college education.

The first bit of news wasn't encouraging. This fall the College Board announced that the average public school tuition had increased by 7.1% year over year. Yikes! That's about 4 percentage points above the inflation rate. Using current tuition, room and board rates from the College Foundation, I calculated the total cost to educate my kids to be $397,263! This finding was mind-numbing at first, but I analyzed the cash flows and discovered that there was hope. With what I've already saved and with continued 529 contributions, my eldest child's education will be fully funded when he starts college. By increasing 529 contributions a bit, I can get my second child's first two years funded by the time he starts his freshman year. Our mortgage will be fully paid off when my third and fourth children are in their junior and freshman years respectively. Providing us some cushion are UTMA accounts for each of the kids and the fact that my earnings should increase in the years ahead. In addition, my wife had a very good job in the technology field prior to becoming a "stay home" mom; and at some point she'll likely return to the work force. What at first seemed daunting now seems achievable with proper discipline and planning – the very things we provide to clients every day.

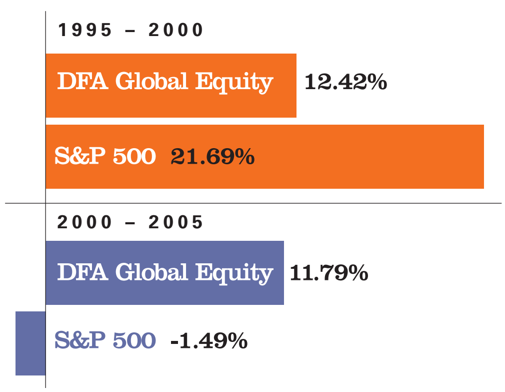
A few days after completing my college funding analysis, my oldest son approached me about the need for some new basketball shoes. "I want those cool Nike Shox," he said. "Son," I replied, "let me tell you a story about a cobbler."

How Have You Done?

We are often asked by prospective clients, "How have you done?" Translated, they want to know the performance of our investment portfolios. While every client's objectives and risk tolerance are different, there are common principles we apply to our investment strategy. We believe adequate exposure to all major asset classes (large cap, small cap, international, emerging markets and real estate) provides the foundation for a successful investment experience.

The chart below illustrates the benefits of proper asset class diversification as represented by the DFA Global Equity fund (DGEIX). The period 1995-2000 marks perhaps the greatest bull market in the last 75 years, which was followed by 3 successive years of negative returns for the S&P 500. Yet, the DFA approach was remarkably consistent through both cycles.

Benefits of Asset Allocation



For periods ending 9/30.

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

Behind the Scenes at Trust Company of the South

- >> **John Slayton** and **Bill Noble** attended the Duke University Estate Planning Conference in October.
- >> **Mike Palmer** attended the NAPFA South Region conference in November.
- >> **John Slayton** is serving as an expert witness on fiduciary law issues in a federal district court case in Seattle.
- >> **Mike Palmer** was featured in Mary Rowland's column in the November issue of *Wealth Manager* magazine.
- >> **John Slayton** moderated a CLE program on the new NC Uniform Trust Code for the NC Bar Association in October.
- >> Please join us in congratulating **Jill Johnson**. Jill successfully completed the November Certified Financial Planners exam. Way to go Jill!
- >> Congratulations are also in order for Operations Manager **Brad Sutton** and his wife, Elizabeth. They are the proud parents of a baby girl, Addison Elizabeth, born December 22.

continued from cover

>> The Morningstar fund rating service fared little better, with its model portfolios lagging the Vanguard Total Stock Market Index from inception to Sept. 30, 2004.

But that was nothing compared to the individual stock picks of analyst gurus featured in a 2000 issue of *Fortune*. Each "all-star analyst" sported a blue jacket, with the cover headline blaring "Let them make you rich."

Oh really? If you bought Oracle at its then-price of $72 because of the star analyst's "target" price of $115, you saw the stock plummet to $13.23 by the end of 2003.

WorldCom was deemed "dirt cheap" at $45 but had become even dirtier and cheaper by the time it sought Chapter 11 bankruptcy protection in July, 2002. In 2001, the Average All-star stock return was -17%, compared to -9% for the S&P 500.

In fairness, there are financial writers that do a commendable job. Jonathan Clements of the *Wall Street Journal* comes to mind; but sifting through what is truly valuable information and what is "noise" can be very difficult. The foremost objective of all forms of media is to generate more advertising dollars. "Sensational" and "salacious" sell. Most media outlets play to what Mr. Wheeler refers to as "those two most common motivators, greed and fear," rather than focusing on what could truly benefit most investors -- defining goals and risk tolerance and constructing well diversified portfolios.

We at Trust Company monitor the financial press, not so that we can chase the latest fad, but rather so we can prepare and prevent our clients from being distracted by the "noise." Our greatest value is often helping clients focus on the really important matters of wealth management – protecting you and your family from the financial consequences of death or disability; funding the best educations for your children or grandchildren; endowing you with a secure retirement; creating legacies for your heirs. Dare to be dull: you'll be surprised at how rewarding it can be.

THE TRUST COMPANY OF THE SOUTH

Raleigh Office

Michael H. Palmer, II CFP®
Principal
919 781.8287
mpalmer@tcts.com

Burlington Office

John H. Slayton, JD, CFP®
Principal
336 538.1000
jslayton@tcts.com

William H. Smith CFP®
Principal
336 538.1001
wsmith@tcts.com

Rocky Mount Office

William H. Noble
Principal
252 451.8728
bnoble@tcts.com