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THIS ISSUE...

Why Should I Care About 'Shadow Banking'?

by John H. Slayton, JD, LLM-TAX, CFP®

Last fall's subprime mortgage meltdown and credit contraction coincided with the section of my Financial Services class at Elon University dealing with banking and the Federal Reserve System, so I taught the classes out of each day's *Wall Street Journal*, rather than the assigned text. What a rare treat for students to learn the process as it unfolded "real-time!" However, as I related each day's events to the intricate workings of the Fed and the credit markets to those eager finance majors, I started to privately question how much of the text material on banking remained relevant today.

The text book describes the "Old World" banking system, where banks took deposits, paid low interest rates to depositors and then loaned the money at higher rates to borrowers, profiting from the margin and creating liquidity in the banking system. Because of this privileged role, banks have historically been heavily regulated and required to maintain adequate reserves as a safety net to the public. The FDIC guaranteed deposits and the Fed was available to ease any liquidity shortfalls. Your local bank made a mortgage to you and either retained it on its books or sold it to Fannie Mae or Freddie Mac.

Articles in today's paper have little to do with this Old World, but focus instead on the new *shadow banking* system. We read that established financial entities have formed off-balance sheet Structured Investment Vehicles (SIVs), that hold exotic derivatives or pools of credit, without any material regulation or reserve requirements. Mortgage brokers flip the loans they generate into large pools and then are securitized and sold. The creativity of Wall Street's financial engineers has been matched with the ability to market these higher yielding instruments to a yield hungry investing public. The size of the subprime mortgage issues that receive such attention pale in comparison to a financial derivative industry that is several times the size of total global banking assets. Often the only reserves built into these SIVs, conduits and pools of securitized credits are the various subordinated higher interest rate slices of the packages. We saw last fall how quickly these lower classes of security collapse in the event of defaults.

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NOTABLE QUOTE

"The only thing new in this world is the history that you don't know."
Harry Truman

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

A Voyage in Steerage

by Mike Palmer, CFP®

It must be January because the newsstands at the grocery checkout aisle are loaded with magazines touting fitness ideas, both physical and fiscal. The February 2008 issue of *Smart Money* magazine offers an interesting example. The cover exclaims "Beyond Mutual Funds: Blue-Chip Stocks, ETFs and Three Other Ways to Boost Your Returns." But of greater interest to me was the editor's page titled "Steering You in the Right Direction."

Several years ago I started scanning and keeping files of stock and mutual fund prognostications from various "pundits and experts." So when I read *Smart Money* Editor Jonathan Dahl's column in the February issue it raised an eyebrow. Dahl asserts that over the past five years 75% of mutual fund managers failed to beat the market. As clients of Trust Company will attest, that contention doesn't come as any surprise to us. However, I felt compelled to test his assertion and sure enough the SPIVA and Morningstar data bear it out.

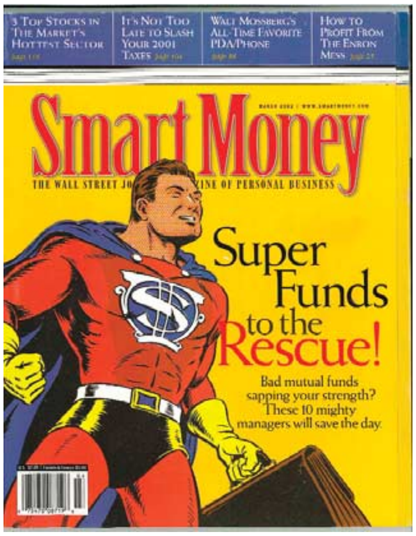
But what puzzles me is Dahl's next contention. Having just made the case for the use of indexing or passive investing, he then states, "That's just one reason we're not reviewing the best mutual funds this time of year as we usually do. Even the humblest of ordinary consumers today have access to more and better information that can help them steer their investing decisions, which means they no longer have to stake their retirement on the fund industry's ho-hum returns." Confused? So I am.

To see just how good a crystal ball the folks at *Smart Money* possess I went back to my old issues to determine how an investor following their recommendations would have fared using a portfolio of their "best funds." The results were interesting to say the least.

In March 2002, with a likeness of Superman adorning the cover and a banner proclaiming "Super Funds to the Rescue" the experts at *Smart Money* picked 10 funds. For the period March 1, 2002 through November 30, 2007 an equally weighted portfolio of their choice funds returned 9.48% annualized. But an equally weighted index portfolio (30% SP500, 30% SP MidCap 400, 30% Russell 2000 and 10% MSCI EAFE) returned 10.37%.

In February 2004 the cover touted "Ten Great Mutual Funds for the Long Haul." Two of the funds profiled were "balanced" funds, so I excluded those from consideration. An equally weighted portfolio of the remaining eight funds produced an annualized return of 9.7% for the period February 1, 2004 to November 30, 2007. An equally weighted index portfolio for the same period returned 11.9%.

If a retirement of stateroom cruise travel appeals to you, then you'd do well to accept the capital market returns available via passive investing. Steering clear of seers, pundits and prognosticators who contend they can "beat the market" will help keep your retirement voyage out of steerage.



Dealing with Life's "Frictions"

by Mike Palmer, CFP®

I'm an avid reader of history, and for Christmas I received Rick Atkinson's *The Day of Battle: The War in Sicily and Italy 1943-44*, the second work of his World War II trilogy. This follows his 2003 Pulitzer Prize-winning *An Army at Dawn*, the first installment in the liberation trilogy which chronicles the Allied invasion of North Africa. Atkinson is superb in revealing the details and subplots of how this powerful moment in history unfolded. Learning about the key players in the struggle and gaining insights into their personalities and foibles is fascinating stuff. But I also find parallels that apply to my craft and help me better serve my clients.

The vast majority of our firm's clients engage us because we place great emphasis on the financial planning component of our client's financial lives. Yet, at the end of the day a "financial plan" isn't static; it isn't a parchment to be framed, followed and festooned with fortune. Life happens, unexpected things occur, mid-course adjustments are the norm, and our guidance at such times provides reassurance and clarity of thought.

As the Allies stormed Italy in September 1943, the invasion plans quickly went awry. The official British military history of Salerno observed, "In the land of theory there is none of war's friction. Commanders know what in fact they did not know…lorries never collide, bridges are always wider than the flood. Shells fall always where they should fall." In Italy, frictions accumulated. Mistakes were made, hitches occurred, all at a heavy cost.

Successful financial planning isn't a one-time thing; it requires adaptation to life's frictions. Careers or business ventures stumble. Marriages dissolve. The health we enjoyed in youth escapes us as we age. Children grow into adulthood and sometimes have difficulty finding their way. A gifted financial planning practitioner possesses patience, understanding, wisdom, expertise and a commitment to always work in the client's best interest. From this combination of skills and talents financial independence and security can be attained, notwithstanding the occasional setback.

Despite inexperience, errors in judgment, mistakes in execution, and fractious infighting between Brits and Yanks, the Allies persevered. Their ability to adapt, at all levels of the chain of command, enabled them to prevail in the Great Crusade.

Achieving financial success is much the same. Life's frictions intervene. A skillful financial advisor knows the terrain and can guide you through the minefields, providing intelligence and experience to accomplish your financial objectives.

Behind the Scenes at Trust Company

- >> **Dan Tolomay, CFA,** joins Trust Company as a Wealth Advisor in our Burlington office. Dan comes to us from Smith Breeden Associates. We are quite excited to have Dan on our team. Please join us in welcoming him.
- >> **John Slayton** was recently certified as an Accredited Estate Planner (AEP) by the National Association of Estate Planners & Councils. The AEP designation is made to estate planning professionals in various specialties (attorneys, CFPs® or CPAs) who meet stringent requirements of experience, knowledge, education, professional reputation and character and agree to adhere to a professional code of ethics.
- >> **Jill Johnson, CFP®**, a Wealth Advisor in our Raleigh office, wed Jeremy Sweat on September 15, 2007. Congratulations, Jill!
- >> **Mike Palmer** attended the biannual DFA College in Austin, TX in November.

Trust Company Opens Charlotte Office

We are pleased to announce the opening of our Charlotte office. Chris Sutherland and Jay Eich, formerly of PricewaterhouseCoopers, have joined the firm as principals and will manage the Charlotte office.

Chris is a CPA and a graduate of Clemson University. Jay is a graduate of Alfred University and holds CPA, CFP® and CPA/PFS designations.

"We believe this development is a tremendous opportunity for our firm," said Trust Company Managing Principal Bill Smith. "Chris and Jay bring a complimentary skill set to our firm that enables us to better serve our existing clients in addition to serving new clients in a very attractive market. Chris and Jay possess a combined quarter-century of financial advisory experience and share our commitment to serving clients in a fiduciary capacity. We think attracting talented professionals of their caliber is a testament to our goal of building the state's premier wealth management firm."

Please join us in welcoming Chris and Jay to the Trust Company team.

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How do these amorphous creations of Wall Street affect me? Abnormal default rates in this *shadow banking* system could result in failures of significant market participants (Bear Stearns?), embarrassment and over-reaction by financial regulators and a marked credit contraction that could lead to, or deepen, a recession. You need not own derivatives or subprime mortgages to be affected by the market fall-out of any hiccups in the shadow banking system. You need only invest, save or borrow.

What can I do?

These risks reinforce the prudence of our basic investment approach – a fully diversified portfolio, using multiple low-correlating asset classes. Chasing the latest, greatest financial engineering concept is unduly risky in today's world. A disciplined, diversified approach, including international and prudent fixed income exposure, should weather the storms of the tempestuous *shadow banking* system. Risk can be limited to an acceptable level. We welcome the opportunity to discuss this with you further.

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