

# The Compass

The Trust Company of the South

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Trust Company of the South is an independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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## Dealing with Event Risk – Is Your Portfolio Protected?

It has been over a year since the terrorist attacks on the Pentagon and World Trade Center, and many market pundits blame the market's dismal performance on the 9/11 tragedy. Our firm is not one to try to predict the short-term direction of the market or spend a great deal of time trying to pinpoint an exact cause for past performance; the markets are simply too complex to do either with any specificity. But what we have spent a good deal of time thinking about over the last year is contemplating "event risk" and what it means for clients.

Investors must constantly assess various kinds of risk; interest rate risk, inflation risk, default risk, exchange rate risk are among the more common. Event risk can be described as the risk that some external event, typically unforeseen, will cause a steep or prolonged decline in the market. Examples of "event risk" over the past three decades include the Arab oil embargo (1973), the Iranian hostage crisis (1979), the Iraq invasion of Kuwait (1990), the collapse of Long-Term Capital Management (1998), and the 9/11 terrorist attacks.

We would argue that never has likely to be greater for the today. Over the last two a smaller place, and investors advancements in technology can be quickly and easily abundant cheap labor, and the have been greatly reduced.

which it could be argued contributed greatly to increased production efficiencies, and perhaps indirectly to the strength of the equity markets during the 1990's, also come with some drawbacks that we are just now realizing.

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These benefits of globalization, which it could be argued contributed greatly to increased production efficiencies, and perhaps indirectly to the strength of the equity markets during the 1990's, also come with some drawbacks that we are just now realizing.

Consider our present defense posture versus our readiness at the height of the Cold War. Our national security has always been directed at threats from nation states. How are we to respond to terrorists whose origins and base of operation may be impossible to detect or track? What use is NORAD when the delivery vehicle for a nuclear weapon may be a shipping container entering through a busy port?

As long as we live in a country that is the economic, military, and cultural envy of the world, we must face the realization that we, not Western Europe, Russia, or China, wear the bull's-eye of fanatics intent on inflicting death and destruction on our nation. Combine this fact with an economically deteriorating nuclear power (Russia), an uncontrollable information source (Internet), and religious fanaticism of the highest order, and one must concede the ingredients for "event risk" have never been greater.

As a trusted financial advisory firm what steps might we take to address event risk? This is critically important for clients whose earning years are behind them (retirees or special needs trust beneficiaries) or those completely dependent on the success of their investment portfolio. How do we counsel a recently retired couple with \$2 million lump sum in their IRA rollover? How do we safeguard the \$3 million insurance settlement for an injured 22-year-old paraplegic? For starters, being too fearful or too conservative is actually counterproductive. In our view, the overwhelming majority of investors face a larger risk in erosion of purchasing power than event risk.

Increasingly, advisors are looking at greater asset class diversification within portfolios and at more non-conventional investments as means to reduce portfolio risk. Our firm is in the process of adding real estate as a separate and distinct asset class within which to diversify client portfolios. Real estate serves as a good inflation hedge, produces solid income, and has a low correlation to stocks. Low correlation means the asset class has historically performed dissimilarly to another asset class. By way of illustration, the NAREIT index returned 13.9% in 2001 while the S&P 500 returned -11.9%.

Our firm has advocated including international equities in portfolios for some time, and our clients have benefited from this exposure over the last 3 years, as our international manager has returned 1.2% during that period versus the S&P 500 decline of 9.2%. We believe international equities, particularly large multinational companies based in Western Europe, will become mainstream investments. There are a variety of reasons for this shift in sentiment, not the least of which is these countries simply aren't the terrorist target the United States is.

Commodities provide another asset class that is generally viewed as defensive, but which may reduce portfolio volatility. Gold is the most well-known commodity, but a basket of commodities, i.e. a commodity index, might include agricultural products (soy beans, corn, wheat, live stock) along with natural resources (natural gas and oil). "Hard" assets generally provide an inflation hedge and have low or negative correlations with bonds and stocks.

Our role as wealth management partners is to constantly explore ways not only to enhance portfolios but also protect them.

- Mike Palmer, CFP®

## Asset Class Correlations

	Lehman Ag Bond Index	S&P 500 (US Stocks)	MSCI EAFE (Int'l Stocks)	NAREIT (Real Estate)	Gold
Lehman Agg	1.00	0.29	0.18	0.20	-0.25
S&P 500	0.29	1.00	0.52	0.53	-0.10
MSCI EAFE	0.18	0.52	1.00	0.34	0.04
NAREIT	0.20	0.53	0.34	1.00	0.22
Gold	-0.25	-0.10	0.04	0.22	1.00

### Turning Lemons Into Lemonade – Making the Best of Market Declines

Market conditions have been tough on everyone; and although our strategy of fully diversifying clients across all asset classes has enabled our clients to weather the last 2 ½ years much better than most, some clients have seen asset values decline. While no one enjoys seeing asset values decline, it affords us the opportunity to do some of our best financial planning work for clients. Here are a few strategies we believe make sense:

- Through the use of individually managed accounts, we are able to selectively harvest tax losses in accounts. Taxpayers can take losses of up to \$3,000 per year against ordinary income (see more on possible increase on page 3), and any excess can be carried forward to future years. Harvesting losses is a strategy all investors should proactively pursue and actually increases after tax returns.
- In September we encouraged several clients to take advantage of depressed stock prices to make annual exclusion gifts often reserved for the Holiday season. The annual exclusion gift limit is \$11,000 per donee, and married couples can combine their gift. If you haven't already done so, now is a great time to make gifts to children or grandchildren.
- Revisit sophisticated wealth transfer strategies like family limited partnerships (FLPs) and charitable lead trusts (CLTs). Discounts on top of discounted asset values offer tremendous planning opportunities. Discounts of 30% are standard for properly structured FLP's. Charitable lead trusts, providing an immediate distribution to charity with a transfer of remainder interest to family upon completion of the trust term, are especially attractive based on current interest rates and low stock valuations. The applicable federal rate (AFR) is currently at the lowest rate since its creation, 3.6%. For CLTs the lower the AFR, the lower the valuation that is placed on the remainder interest, allowing for the "zeroing out" of the interest passing to family members thereby decreasing the gift tax impact.

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For example, based on the current AFR, a trust payout of 7% would zero out in 21 years, 8% in 17 years, and 9% in 14 years. Clients with estates in excess of \$3 million should give consideration to charitable lead trusts as a vehicle for gifting to children or grandchildren while also furthering one's charitable interests.

- Mike Palmer, CFP®

### **On the Horizon**

There are several recent legislative and administrative developments our clients may find of interest. Earlier this month House Republicans presented bills providing benefits to many investors. Among the elements in the bill are:

- An increase in the maximum tax deduction for net capital losses from the present \$3,000 limit to \$8,250 effective January 1, 2002
- Raises in age taxpayers must commence required minimum distributions from IRA and 401(k) plans from 70 ½ to 75 in 2007
- Accelerate the increase in IRA contributions to \$5,000 beginning in 2003

Democrats are expected to oppose many of these changes, but the net operating loss has been locked at \$3,000 since 1978 and is long overdue for adjustment.

The IRS announced a modification of the Section 72(t) rules governing distributions from qualified plan (Revenue Ruling 2002-62). Under 72(t) taxpayers can avoid 10% penalty on withdrawals prior to age 59 ½ by using one of three approved substantially equal periodic payment exceptions. Three years of staggering stock market declines have created compliance hardships for some taxpayers. Ruling 2002-62 provides for a onetime switch in calculation method, providing much needed financial relief for some individuals.

Additionally, a recent IRS Private Letter Ruling makes it easier for non-spouse beneficiaries of qualified plans to stretch the distribution of plan assets over the beneficiary's life time.

Finally, the North Carolina legislature recently passed laws that conform state inheritance tax law with federal estate tax exclusion amounts and IRA deductions.

- John Slayton

### **Diversification v. Diversification?**

As of the end of the 3<sup>rd</sup> quarter, stock prices, as measured by the major indices, are back to August 1997 levels and off nearly 50% of market highs of 2000. The length and depth of the current decline parallels the 1972-74 bear market and combined with historically low bond yields, leaves many investors in a quandary as to what strategy to follow. Our clients understand the long-term perspective required of equity investors and appreciate the thorough asset allocation which is the foundation of our firm. We think an important distinction exists between *diversification* and *asset allocation*. Many of our peers practice diversification, using in-house investment management to construct a portfolio of 25-40 stocks spread across all industry sectors. But too often these portfolios are constructed entirely of large cap stocks. As recent market performance proves, this leaves clients exposed to undue risk.

A diversified portfolio may not be properly asset allocated, but all our asset allocated portfolios are diversified. We advocate both diversification and asset allocation. Over the last few months we have remained focused on several fundamental principles:

- Build asset allocated portfolios and adhere to rebalancing portfolios to the target allocations as circumstances warrant
- The art of successful investing is counterintuitive. The time to buy is when everyone is scared and you are a bit scared yourself
- Investment management is only one component of sound, comprehensive financial planning

### **Quote of the Quarter**

“Most people shouldn't use a commission based advisor. The conflicts of interest, whether real or perceived, are genuine – they're conflicts. I think the era of the commissioned broker is behind us and the era of the advisor is going to be the future direction... preferably one with the Certified Financial Planner designation who considers your overall financial picture.” -Arthur Levitt, former Securities and Exchange Commission chairman

For additional information, or questions regarding any of the material in this issue of *The Compass*, please give us a call.

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Address Correction Requested

