Sentinel Trust Company

On Watch

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SENTINEL HORIZONS

Our Investment Outlook

D. FORT FLOWERS, JR.
President and CEO

In This Issue:

Welcome to the first edition of *On Watch*, a quarterly publication by Sentinel Trust Company designed to spotlight wealth management issues, trends and opportunities relevant to ultra-high-net-worth families and their businesses.

Some investment firms report only on past performance. At Sentinel, we believe in looking ahead and anticipating the market in order to help our clients make wise investment decisions.

Dr. Bruce L. Swanson, Sentinel's Chief Investment Officer, writes an annual investment strategy paper, *Sentinel Horizons*, which you may have already received. In past years, he highlighted problems like the technology and credit bubbles well before they burst. Bruce also had repeatedly criticized Fed Chairman Greenspan's policies, believing that ultimately they would lead to a bad ending.

Horizons allows us to communicate Bruce's investment thoughts to our clients. Equally important, the macro views that Bruce develops in his process of producing *Horizons* provide a top-down perspective that reinforces or challenges our bottom-up valuation work. Both are necessary in implementing our philosophy that valuation sensitivity in investment decisions, both within and across asset classes, is critical to reducing risk and increasing returns over the long term.

Story continued inside ...

Story continued from front ...

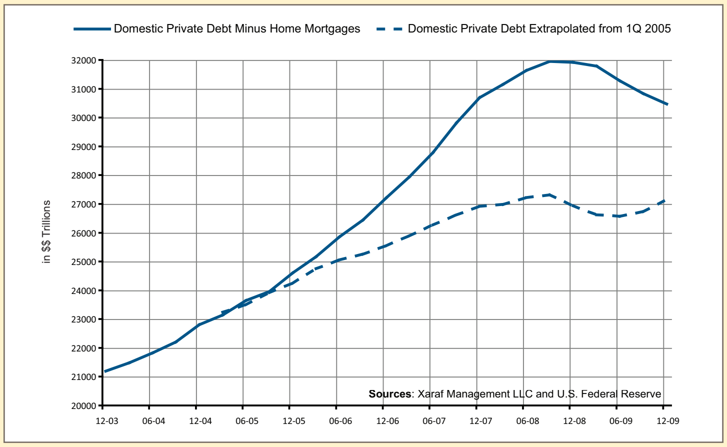
So what does Bruce see on the horizon?

HERE'S A SUMMARY OF KEY CONCLUSIONS FROM THIS YEAR'S *HORIZONS* TITLED: "GLOBAL WARMING – NOT JUST YET."

Global Economic Growth Forecasts

The consensus view is that recovery in the developed world, combined with continued growth in emerging market countries, will lead to strong global growth. We believe that this synchronized **global growth scenario seems overly optimistic**. The expectation of strong global growth excessively downplays developed-countries' issues related to necessary tax increases and ongoing private-sector financial restructuring as businesses and consumers lower their debt. (*See Figure 1 - The Credit Bubble.*) In addition, emerging market countries (especially China) face monetary tightening in order to fight asset bubbles. All of these factors will depress economic growth.

FIGURE 1 - THE CREDIT BUBBLE

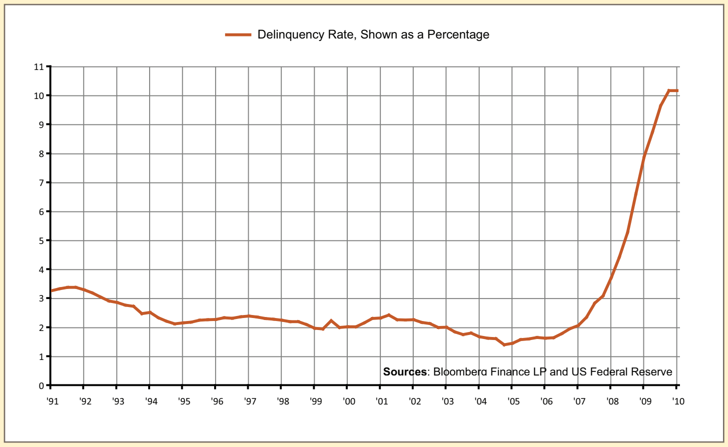


This graph provides a good description of the "credit bubble." The upper line shows total U.S. private market debt (excluding home mortgages). The lower line shows how much debt there would be if debt levels had stayed at a constant level of GDP since 1st Quarter 2005. Clearly, a significant gap remains before the U.S. is back to a more "normal" level. Thus, there will be continued downward pressure on economic growth.

Inflation

Because of continued downward pressure on both housing prices from foreclosures and labor costs from high unemployment, **inflation is not expected to be a problem during 2010 or 2011**. However, **inflation may be a significant concern in 2012** as housing prices begin to rise from foreclosure-induced lows and unemployment falls, allowing labor costs to move upwards to a more normal percentage of corporate profits. (*See Figure 2 - U.S. Residential Delinquency Rate.*) Appreciation in China's currency resulting in higher prices for imported goods could exacerbate the problem. Finally, the Fed may err on the side of being too late to move to control inflation.

FIGURE 2 - U.S. RESIDENTIAL DELINQUENCY RATE



The Residential Delinquency chart shows mortgage delinquencies as a percentage of total mortgage loans. It likely will be some time before delinquencies return to normal and foreclosures exert less pressure on housing prices.

Valuations

In sharp contrast to March 2009 when markets hit their lows, valuations are broadly neutral across major asset classes, providing neither a valuation "cushion" in the case of disappointment nor significant resistance to further moves upward. The magnitude of economic uncertainty, including the unquantifiable risks associated with Obama administration policies, suggests posturing portfolios somewhat defensively despite our neutral viewpoint on valuation.

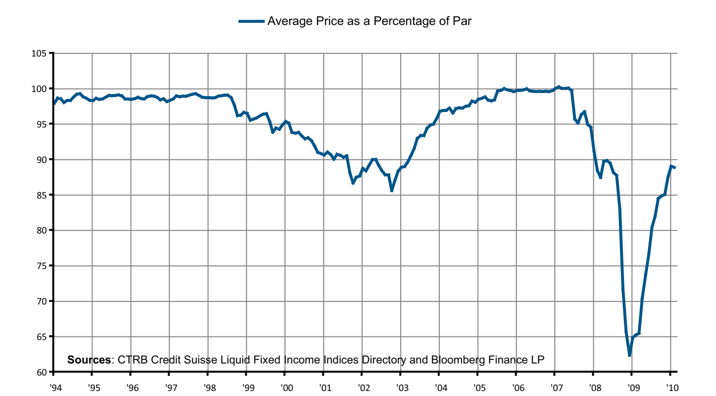
Investment Portfolio Considerations

Because significant risks remain, domestic and international equity holdings should be below long-term targets.

Domestic equities are modestly overvalued, as aggressive earnings assumptions are required for the market to be fairly valued. Within domestic equities, economically insensitive sectors (such as healthcare and telecommunications) should be emphasized both for risk-control purposes and because they appear attractively valued. Japan remains our favorite international equity market as Asian growth should lead to significant earnings recovery from depressed levels and, with inexpensive valuation (65 percent of companies sell for less than book value), there is some downside protection if growth disappoints. Overheated commodity-based markets with overvalued currencies (such as Australia and, to a lesser extent, Brazil) are the least attractive.

After our spectacularly successful focus on high-yield debt last year, this year's **fixed income** focus is on much higher quality market segments (*see Figure 3 - Leverage Loan Index*). Allocations to high-yield bonds have been mostly eliminated and holdings in the entire asset class should be below long-term targets. Municipal bonds with more than five years to maturity remain in portfolios. However, we have moved shorter maturities to taxable government bonds, which are more attractive on an after-tax basis, especially when considering liquidity.

FIGURE 3 - LEVERAGE LOAN INDEX



Sources: CTRB Credit Suisse Liquid Fixed Income Indices Directory and Bloomberg Finance LP

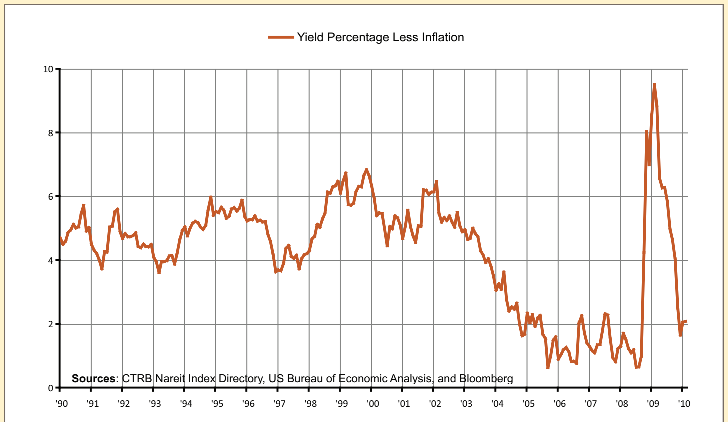
This chart shows prices for a portion of the high-yield market: leveraged loans (loans to companies that have gone private through leveraged buyouts). Note the sharp fall in 2008 and subsequent rebound in 2009. Even though there are still significant economic issues outstanding, prices have approached December 2007 levels, which seems overly optimistic.

Unlike last year, portfolios should emphasize **hedged strategies** over their long-only counterparts. Because of recent significant market recoveries, return prospects for stocks and corporate bonds are subdued. Also, since the market recovery was somewhat indiscriminate, opportunities abound for specialist hedge fund managers. Finally (and somewhat surprisingly), the cost of downside protection employed by hedge fund managers is currently unusually inexpensive.

Dislocations in the debt market are driving allocations to **private equity**. Our emphasis remains on funding lending strategies to those parts (e.g., real estate) of the private debt markets that are still stressed. Interestingly, in some markets (notably European leveraged buyout), financing costs are cheap relative to equity valuation, making participation as a leveraged equity investor attractive.

While private real estate debt is attractive, publicly traded **real estate investment trusts** (REITs) appear overvalued on an absolute basis as well as relative to their private real estate counterparts (*see Figure 4 - REIT Dividend Yield Less Inflation*).

FIGURE 4 - REIT DIVIDEND YIELD LESS INFLATION



Sources: CTRB Nareit Index Directory, US Bureau of Economic Analysis, and Bloomberg

On this chart, the lower the yield, the more expensive REITs are priced. Over the long term, REITs typically have yielded between 3 1/2 percent and 6 1/2 percent after inflation. After the significant market rally, on this measure REIT valuations have rebounded back through their historical ranges and are approaching pre-crash levels.

Summary

The combination of investor complacency and current valuation levels price in a fairly benign economic forecast. Economic disappointments may result in significant downward moves in markets, so portfolios should be invested with this possibility in mind. Fortunately, adding downside protection is unusually inexpensive.

Our primary tool for positioning client portfolios is the relative attraction of various asset classes on a valuation basis. Each year, the economic issues reflected in *Horizons* either reinforce or dilute those valuation-based calls. This year, the more pessimistic view expressed in *Horizons* tends to confirm conclusions from Sentinel's other valuation-based work.

If you would like a copy of Dr. Swanson's full report so you can examine the thought processes that led to these conclusions, please contact Anthony DeToto at ADeToto@sentineltrust.com or 713.559.9578.

It's Summer – Time for Heir Conditioning

ROSS W. NAGER, CPA
Senior Managing Director

A new client was planning to test his children by giving them money on their 30th birthdays. If they used it wisely, he would give them more; if not, he would adjust his estate plans accordingly. His first question: "Do you think I should give them $1 million or $5 million for the test?"

I told him he was starting with the wrong question. Instead, he should ask, "What can I do to prepare them for the wealth that I might choose to give?" The answer is a process I call "heir conditioning," a phrase I first heard from my former Arthur Andersen partner Mark Vorsatz, now with WTAS LLC in San Francisco.

Although the specifics should vary from family to family, heir conditioning generally involves:

> teaching the rights and responsibilities associated with wealth and stewardship;

> developing cooperation and accommodation among heirs when family business or investment interests will be intertwined;

> understanding and respecting family heritage;

> developing work ethic and a sense of moral and social values; and so much more.

Only after gaining these lofty skills is it appropriate to "test" the kids as my client proposed.

Parents too often assume that the kids somehow learn their parents' views, philosophies and business/investment skills through osmosis or, perhaps, in school. For most kids, that assumption is wrong. Other parents assume that their great estate planning advisor will create the perfect documents to manage the wealth when they leave the scene. But, in all my years advising wealthy families, I have never seen a document raise a child.

If you want to see the kids succeed, they need to gain the necessary skills. Certainly, you have a lot of knowledge to offer, but if your kids are like mine and they don't hang on your every word, consider involving others. It's a process that takes time. And, it is never too early or too late to begin it.

Our Clients Speak ...

"We were experiencing a great deal of anxiety about discussing our new-found liquidity (from selling our business) and our plans with our adult children. Your idea about asking our children for their opinions and concerns prior to telling them about our plans was brilliant! Among other things, you suggested asking them about why parents might worry about the effect of money on their kids and finding out about their life objectives. You said that we should talk with them about our planning ideas because we know that our planning will affect them and their children. The result was a terrific discussion and greatly improved relationships."

FLP

PROPERLY OPERATING AN FLP

Family limited partnerships and limited liability companies may be the most popular estate-planning vehicle these days because of their versatility in maintaining and transitioning ownership and control of family assets. They also can provide gift and estate tax-reduction opportunities. Yet, many taxpayers risk these tax savings because of poor maintenance after the plans are put in place.

The problem boils down to a simple statement. If you don't respect the entity, the IRS won't either. Indeed, many successful IRS challenges in examinations and the courts are the result of taxpayers failing to operate the entity in a business-like manner. Here are some examples of actions that can contribute to failed tax-savings:

- Senior generation family members take money out whenever they need it, without regard to (or at least, not documenting) the entity's needs.
- Money is distributed to partners (or used for their benefit) disproportionate to ownership interests.
- Personal bills are paid from partnership accounts (whether or not an account receivable is recorded in the partnership's books).
- The partnership does not conduct meetings or votes as required by the partnership agreement (or those meetings and votes are not properly documented).
- Partnership income is deposited into personal accounts.
- The partners use partnership property for personal purposes.
- The partnership loans money to partners whenever they need it, and no one documents the appropriateness of doing so from a business/investment standpoint.
- The partnership fails to maintain appropriate books and records.
- Documentation and/or timing of transfers of assets into the partnership are not accurate.
- The partners fail to take and document actions consistent with the stated business/investment reasons for the partnership's creation (e.g., if a stated reason is to transition management, there should be educational and meeting activity geared toward enabling that transition).

Most people fail to properly administer their family-controlled entities because administration does not in itself make money and it is not as interesting as normal life and business activities. But, good administration by you, family office personnel and other advisors is critical to achieve tax and other objectives. Oh, and if you find you've done something wrong in the past, fix it as soon as possible.

For more information on getting the most out of your Family Limited Partnership, contact Ross W. Nager at RNager@sentineltrust.com or 713.630.9646.

"IF YOU DON'T RESPECT THE ENTITY, THE IRS WON'T EITHER."

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.
For further information, please contact Anthony DeToto, Senior Client Service Officer, at ADeToto@sentineltrust.com or 713.559.9578.

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