



Quarterly Update April 2009

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How Bad Is It?

Peter Sherlock

There is no denying the current economic environment is the worse that has been seen in the U.S. in at least 25-30 years. That appears to be part of the problem; most anyone under 50 years old has never experienced a real recession. However, we have experienced difficult times before without a depression, and to get a sense of magnitude, take a look at the “misery index”, which was devised by an economic adviser to President Kennedy to gauge the pain of economic crisis. The measure adds together the unemployment rate and the inflation rate. Take a look at the following chart:



	Unemployment	Inflation	Misery Index	30-yr. Mortgage
Current	8.5%	0.0%	8.1%	4.8%
1981-1982	10.8%	14.6%	25.4%	18.5%
1973-1975	9.0%	12.2%	21.2%	10.0%

So, while the current environment is horrible (particularly for those who have lost their job or house), the misery index has a long way to go before it reaches the level of distress it measured in the early 1970s or early 1980s. In addition, as Alan Reynolds pointed out when he referenced this misery index in the Washington Post, getting a sense of where mortgage rates are further confirms how difficult times were in previous recessions. Could it be that the distance from previous periods of real economic difficulty makes this one seem so much worse than those previous recessions, especially since so many of us have no real memories of any previous real economic distress?

With no great surprise, the press, media and pundits are full of comparisons and comments regarding the current economic environment and the Great Depression. While of course no one knows what the future holds, there are some important differences

and facts about the current economic environment and the 1930s that warrant consideration. First, there are many economic safeguards in place today that didn't exist in the 1930s: FDIC deposit insurance, SIPC brokerage insurance, unemployment insurance, a vastly expanded Social Security program, as well as Medicare and Medicaid. Second, our policy responses, first monetary policy and now fiscal policy, have been immediate, meaningful, and in complete contrast to the approach taken in 1930, 1931, and 1932. At that time, the reaction was to pull money out of the system, and to try and balance the federal budget. Now, we are doing the exact opposite. An interesting note about the 1930s was that it was not a decade-long period of economic malaise. In fact, it was a period of two very difficult economic slumps - August 1929 to March 1933 and May 1937 to June 1938, which actually sandwiched a fairly active economic expansion/recovery of April 1933 to April 1937. Some of the policy decisions of the time

were really remarkable in retrospect: a 200 basis point increase in the discount rate in a one-week time span in October of 1931, a more than 100% increase in marginal income tax rates in 1932, and of course, the infamous Smoot-Hawley tariff legislation which heavily taxed imported goods and soon led to a collapse of global trade. The infamous bank failures of the early 1930s led to 9,100 commercial bank failures, with a contraction of bank deposits by 37% in the four years ending in 1933. Contrast that with today, where we have federal deposit insurance that has allowed for a relatively satisfactory transition of the bank failures that we have seen to date. Most importantly, we have seen an unprecedented increase in bank reserves – up over 148% in 2008 – as the Federal Reserve is essentially flooding the system with funds. This, of course, is a complete contradiction to what occurred in 1929 through 1933.

What does all this mean? Well, we of course can't be sure. But as Paul Kasriel, a highly-regarded economist of Northern Trust points out, "If the federal government embarks on a large spending spree and the Fed "prints" the money to fund the spending, then the pace of real economic activity is bound to increase. How long it will take for higher prices to begin to erode real activity is another question. But never underestimate the initial positive impact on aggregate demand of that powerful combination of increased federal government spending/tax cuts and a central bank running a monetary printing press at a high speed." Although the timing of the impact of these stimulative actions is, of course, unknown, Kasriel does feel that the likely long-term ramifications of these actions is an increase in the rate of inflation.

Are We There Yet?

Chris Cassidy



An effective way to protect one's portfolio over the long-term from the risks of inflation is to own assets like stocks. Markets are inherently unpredictable in the short-term, and during uncertain times, such as these, investor emotions can swing asset prices drastically in either direction from day to day.

Since neither we, nor anyone else, can know exactly where the bottom is in equity markets, it is important to reiterate what we do know. Equity markets are inherently volatile in the short-term, but remarkably stable over the long-term. For example, the best one-year period for equity investment from 1926-2008 was 1933 when the S&P 500 returned a 54.2%. The worst one-year period for investment was 1931 when the S&P 500 lost 43.1%. These are enormous differences in returns and underscore the fact that short-term equity market performance varies tremendously from one year to another.

Despite this short-term volatility, the long-term performance numbers for the S&P 500 are remarkably steady. The worst ten-year pe-

riod for the S&P 500 since 1926 was actually the past ten years (1999-2008) with an annual loss of just 1.38%. The second worst ten-year period was 1929-1938 with an annual loss of just .9%. The best ten-year period was 1949-1958 when the S&P 500 returned 19.9% annually. As these examples illustrate, equity market returns are significantly less volatile when investors take a long-term view of the market.



As humans we struggle with many cognitive biases when making decisions. One such bias is the tendency to weight recent events much more heavily than past events whether or not it is appropriate for making a given decision. Since the S&P 500 fell 37% in 2008, and has not performed well for the past ten years, investors have started to believe that poor equity performance will continue indefinitely. People ask us, "Why should I be invested in stocks when they have done so poorly?" Inter-

estingly, the years following long periods of poor equity performance have historically been the best times to buy equities. When ten year annual total returns fall to 1% or less, the next ten years produce an average annual return of 13.8%. From the fourth quarter of 1938 to the fourth quarter of 1948 annual returns were 10.1%. From the third quarter of 1974 to the third quarter of 1984 annual returns were 32.5%.



In addition to questions about the stock market's bottom, there is a lot of uncertainty surrounding the general health of both the domestic and world economy. We have witnessed un-

employment climb above 8% and the home builder, as well as several manufacturing indices, are at historical lows. Certainly the unemployment rate could continue to climb as businesses layoff workers in an effort to cut costs and combat slowing demand. Many companies will report earnings at the end of the month, and it is possible that those numbers could very well disappoint Wall Street. However, it is important to note that the longest recessions since World War II lasted only sixteen months (November 1973-March 1975 and July 1981-November 1982). According to the National Bureau of Economic Research, the current recession began in the fourth quarter of 2007 meaning it has lasted about sixteen months. Consequently, we have already matched the longest recession since World War II.

Admittedly, Trust Company of Vermont does not have any control over where the market bottoms or when the economy rebounds. What we can control is the quality of the assets that we buy and hold. During this recession we have been very conservative with fixed income investments buying only investment grade municipal bonds, government agency bonds and TIPS. On the equity side, we have been favoring large cap companies with strong balance sheets over small caps stocks or highly leveraged companies. Since we do not ordinarily purchase actively managed mutual funds, we can control the quality of the assets in our accounts, and can tailor these assets to meet the individual needs of our clients.

Go raibh maith agat

I first met Ed Safer in December of 1970. Although he wasn't Irish, he felt compelled to tell me an Irish joke designed to provoke rather than enlighten. In retrospect, it was an ironic encounter. Ed was a man who enlightened rather than provoked.

Ed died on January 23rd. He will be sorely missed by all of us at the Trust Company of Vermont. He and his wife, Norma, were instrumental in helping us start the Trust Company and we will be forever in their debt. He had unwavering confidence in us which helped us get through those days when ours wasn't so steady.

Although trained as an electrical engineer, Ed shifted careers when he arrived in Brattleboro to take a position as a stock broker with Burgess & Leith. So we crossed paths early and often. Mentor and friend to many of us at the Trust Company, we salute you Ed with a Gaelic "Thank You".

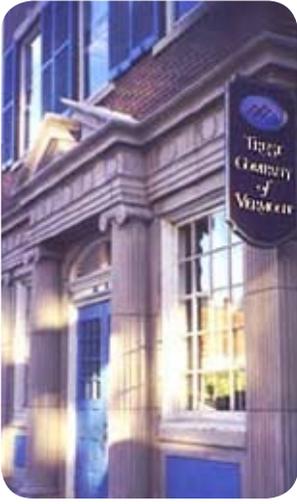
-Jack Davidson



Edward G.
Safer
1927 - 2009

When one decent man casts a pebble in the pond the ripple effect can be enormous, as it has been for us at the Trust Company.

Thank You Senator Gannett



On June 3, 1999 I began my first day at the Trust Company of Vermont by entering the doors of our current headquarters at 151 Main Street in Brattleboro, having just negotiated a lease with the building's owner, Robert T. Gannett.

Senator Gannett went out of his way to support us with a "sweetheart lease" that we feel was instrumental in the success of our company. As we all know, first impressions mean a great deal and this former bank building was ideal for a start-up trust company.

He has been our gracious landlord for ten years. More importantly, he has been our supporter. So it is with heavy hearts that we leave this wonderful building and his stewardship. We had expected that this would be our home in perpetuity. We had not anticipated that we would need more space.

Thank you, Senator Gannett,
for all you have done for us.

Jack Davidson

Our New Home in Brattleboro



As of July, we will be welcoming clients to our new home in Brattleboro at 86 Linden Street.

We have purchased an ideal and comfortable building adjacent to the Brattleboro Common.

There will be more room for both clients and staff, and parking will now be available. We

have scheduled the move for mid-June and are optimistic it will be a seamless transition.



Questions of the Times

Ellen Lowery

Take the dramatic market downturn and ongoing recession, add distressing cases of weak corporate ethics and even outright fraud, and its no wonder investors feel insecurity lurking at every turn. Where you entrust your assets is serious business, and a properly run firm should be able to answer questions like these.

How do you know the activity you see on a statement is real?

This question comes courtesy of Mr. Madoff, in the wake of the incredible news that his clients' statements were pure fabrication. Many details remain to be determined about the Madoff scandal, but it has been widely reported that the many trades reflected on the fictitious statements never actually happened! At TCV, our statements are produced by an independent third party, the Sungard Trust accounting system, on a separate computer system that has independently recorded the transactions executed on your account as reported by both brokers and our asset custodian, the Bank of New York. In the case of Mr. Madoff, it has been reported that his firm both had actual custody of his clients' assets in-house and client statements were also produced internally, on a printer reported not even connected to their computer system.



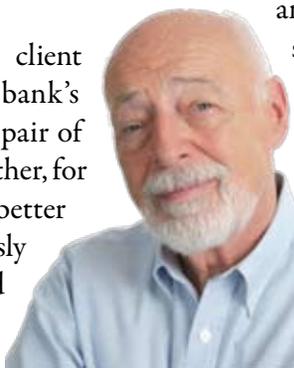
vaults and with independent asset registration accounting procedures. BONY is a regulated institution itself, and we receive detailed yearly audit reports from a major CPA firm as to their practices and controls. Best of all, client asset positions are independently matched by them to our records every business day, and we receive and reconcile reports of same on a daily basis.

Do you have a rating? Who does it and can you tell me what it is? What oversight is there?

The patchwork of federal regulators, such as the SEC, FDIC, OCC, OTS, etc, have been much in the news lately. One overdue byproduct of the recent economic crisis may be a more coordinated regulatory approach from federal agencies. TCV, however, is a state-chartered institution and, as such, is regulated and examined by the Vermont Department of Banking, Insurance, Securities and Health Care Administration (BISHCA). We appreciate and benefit from BISHCA being close at hand and accessible, and receive thorough and regular examinations for both "safety and soundness" and information technology practices.

Where are my assets, really?

When I started in trust auditing in 1982, client trust assets were actually maintained in a bank's local Trust Department vault. Once a year a pair of internal auditors would tether themselves together, for purposes of dual control, and then spend the better part of 3 weeks crammed in a vault, tediously matching up thousands of stock and bond certificates (and the occasional Kruggerrand) to lists of client account assets. It was slow, error-prone and guaranteed to dull enthusiasm for both trust auditing and one's colleague. Today, many stock certificates are not even in physical form, but rather recorded ledger-style, much as transactions are in your checking or savings account. In either case, client assets and ownership records are housed and processed at our asset custodian, the Bank of New York, in elaborate



Although examination results and ratings are shared with an institution's management and Board of Directors, neither BISHCA nor federal regulators allow the disclosure of ratings, even if favorable, with the public. In addition to our regular BISHCA examinations, TCV has an internal auditor on staff, who reports directly to the non-employee board members who comprise the Audit Committee. An internal auditor reviews day-to-day procedure/policy conformance and regulatory compliance. Finally, an outside CPA firm conducts a yearly audit of TCV's financial statements. Taken as a whole, these various components aim to provide a comprehensive, multi-faceted oversight system of independent review.

The Future of the Trust Industry

Employee Ownership & the Trust Company of Vermont

Jack Davidson

The recent market turmoil seems to be focused on sub prime mortgages, bankers and Wall Street. But this is a “perfect storm” and there are other parts to this experience that reveal a fundamental change in a number of areas, not the least of which is the impact on us as a result of the Internet and the related technologies.

Change arrives in different ways. If it starts arithmetically (2-4-6-8-10) you can see it coming and usually have time to adapt. If it comes exponentially (2-4-16-256-65,536) it may start out looking like you have time to adapt and then you discover that you do not. Old line newspapers seem to be dying off daily. Is it the downturn in the economy? No. It's the Internet. Did the industry see it coming? Yes. They simply didn't have enough time and/or perhaps the creativity to make the necessary changes to survive.

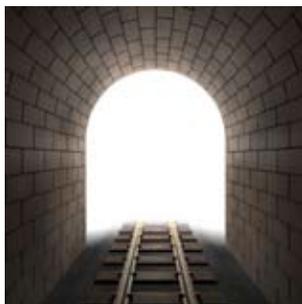
I used to think that if our managers could spot exponential growth we would spot trends early enough to excel as stock pickers. I have since concluded that no matter how good a mathematical formula is, it will usually have very little to do with good long term investment performance.

There is currently some debate as to whether the current problems on Wall Street were caused less by greed and more by a failure of the investment community to comprehend the impact of the newly-created investment vehicles.

There is an old saying I am particularly fond of: “The light at the end of the tunnel is a train”. Using this as a metaphor for change, I think there are two appropriate responses. You figure out how to get out of the way. Or, better yet, if the train is going your direction, try to get on it. I think the most effective way of dealing with change is to first seek a level of understanding that will allow you to see the forest for the trees. It's hard to see trains when you are looking down at incomprehensible algorithms. Then the next step is to recognize that some things don't change. Review your core values on the theory that some values are immutable. It's easier

to see a train when you are looking up. Moreover, who wants to get on a train that takes them ultimately to a place they don't want to go?

In his book “Outliers” Malcom Gladwell suggests that it is not how much money we make that ultimately makes us happy. It's whether the work fulfills us. He cites the three elements to finding fulfillment as autonomy, complexity and a connection between effort and reward. As an employee-owned company, we tend to score higher than most on autonomy. There is no question that we score high on the complexity scale. It's in a connection between effort and reward that our employee ownership gives us a competitive advantage. We get to design our level of service and it is not influenced by outside shareholders. Most of us, if not all, wandered into this industry, and we stayed because we enjoyed the relationships, the problem solving, and the rewards of clients who appreciated our efforts.



We are fortunate. We are in a relationship business where core values are essential and unchanging. If we had to produce widgets at the lowest cost, we would probably not survive. We would be reluctant to outsource.

We think we use technology effectively (in our prior incarnation at Vermont National we were using E-mail in 1985), and we are thankful that we are not in the technology business. We are also aware that we need more people under age 27, the cutoff age for technology awareness, and that we better start twittering soon.

So as an employee-owned company we think we are better equipped than many of our counterparts in dealing with change simply because we will remain consistent in maintaining relationships with our clients. That said, we need to understand the impact of this “perfect storm” on our investment choices. Will we succeed? Yes. We have been trained to avoid trains coming at us. Will we find the better investment choices? I am optimistic. I simply think we need to focus on companies that have immutable values that resonate beyond change.