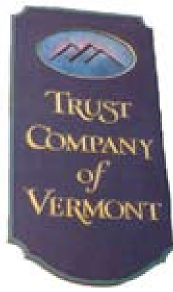

Quarterly Update

January 2008

Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans ◆ Stowe

The Year Ahead in the Financial Markets

Christopher Cassidy, Investment Officer

The headlines from the past two months would suggest that 2007 has not been a good year for equity investors, and that 2008 could be even worse. It seems like every time we pick up the business section of a newspaper, we read stories about mounting sub-prime mortgages losses, $100 oil, the plunging dollar, waning consumer confidence and the increased likelihood of a recession. Although there are numerous pressures facing the stock market and the United States economy, the economic outlook may not be as bleak as some headlines suggest.

Despite more than $50 billion in sub-prime write downs, $90 oil, and a U.S. dollar on par with the Canadian dollar for the first time since 1976, the S&P 500, including dividends, has generated returns just north of four percent this year. Some of the trends that helped the S&P 500 stay in the black in 2007 should continue to help equity performance in 2008, including reasonable valuations, strong corporate balance sheets and a flexible Federal Reserve.

In our 2007 Outlook, we noted that equities, as an asset class, were selling at more attractive valuations than bonds. This remains true heading into 2008, with the 12-month forward P/E ratio of the S&P 500 significantly below the historical average for periods of comparable inflation. The relatively low valuation on equities translates into an earnings yield that exceeds six percent versus a 10-year Treasury yield of 4.25%. Historically, the market tends to do much better when earnings yields are high relative to Treasury yields.

In addition to having attractive valuations, many companies currently have very strong balance sheets. The non-financial companies in the S&P 500 boast collective cash balances of $800 billion, which is double the historical average. These strong financial positions allow companies to invest in capital expansion, recruit new employees, make strategic acquisitions, increase dividends, and repurchase shares.

The Federal Reserve has stated that it will be flexible and vigilant in its attempt to ameliorate the current lending and housing market crisis. The Fed cut the federal funds rate by one quarter of a point last week, and also cut the discount rate for the fourth time since August. The Fed is implementing policy measures such as freezing rates on certain sub-prime mortgages and offering banks special funding at below market rates to encourage lending. Although we do not believe that the Federal Reserve can solve all of the problems facing the credit and housing markets, its flexibility and responsiveness should help lead to a softer landing.

In our opinion, the major risks to positive equity returns in 2008 are inflation, geopolitical events and a slowdown in consumer spending.

Inflation, which has been relatively benign for the past several years, is one of the biggest risks facing the stock market. Overall consumer prices rose by a seasonally adjusted .8% in November, which was the largest monthly gain in two years. If consumer prices continue to increase at a faster than anticipated rate, it could force the Fed to implement a more contractionary monetary policy, which would negatively impact the stock market.

While less likely than an acceleration in inflation, geopolitical risks and the potential repercussions from such events will continue to threaten equity returns. Political tensions in many parts of the world, including the Middle East, pose a threat to investor confidence, and have historically caused volatility in the stock market.

Although inflation could cause a downturn in the stock market, a slowdown in consumer spending would certainly curtail economic growth. With oil prices widely expected to stay above $60 a barrel in 2008, combined with high health care and education costs, the U.S. consumer could see a decrease in disposable income. Consumption currently accounts for more than two thirds of gross domestic product (GDP), and a significant pull back in consumption would limit economic growth in 2008.

For 2008, we see economic growth slowing to around one percent, and predict equity returns in the mid to high single digits. With the slowing U.S. economy, we favor large-cap companies with strong balance sheets and a track record of profitable growth. Diversification across both sectors and geographic areas is of paramount importance, as returns could differ widely for different segments of the economy, and different regions of the world.

Statement Changes

The format of your account statement has changed. You'll find it printed on both sides, with pre-punched holes for easy filing. We hope you'll find the new format more convenient.

If you'd like to eliminate even more paper, you may want to consider signing up for online statements. You'll get the same format, with quicker access than waiting for the mail, all over a secure internet connection. You would continue to receive a printed year-end statement. Please contact your Administrator if interested.

Pictures Sometimes Speak Louder Than Words

Christmas 2000

Our first statewide Christmas party was celebrated in Quechee in December of 2000. This year we met at the Trapp Family Lodge and marked the closing of our ninth year with a sense of gratitude that we are all still here….. and also befuddlement…how did so many years go by so quickly?

Christmas 2007

Joint Trusts - Part II

No doubt our readers have been pacing the floors at home waiting for our second installment on the use of joint-name trusts in estate planning.

In our July 2007 newsletter, we provided background illustrating why joint trusts for married couples are increasingly relevant to our clients. We touched upon three of them – the Basic Joint Trust, the Disclaimer Joint Trust and Tax Plan Joint Trust, which is useful for couples who will need to use both of their estate-tax exemption amounts.

In this special second section, we expand on the Basic Joint Trust and Disclaimer Joint Trust.

We hope these articles will help you understand the basic principles and circumstances that are driving the use of joint trusts, and we hope you will ask about them.

We should apologize in advance for the further use of a nautical analogy. Perhaps because the analogy works so well, we are going to continue comparing these trusts to ships and the planning environment to oceans and watercourses. Like navigators, we are trying to help our clients and their advisers see channels of opportunity and guide them away from submerged rocks and hazardous currents. The entire effort is a venture involving teamwork and the mastery of basic concepts, all harnessed to provide smooth sailing.

None of us at the Trust Company got into this business for the excitement, but we find nevertheless that our changing economic, social, and tax environments are prompting creative ideas and providing very interesting opportunities. Such is the case with joint trusts.

Learning the Ropes

All three types of joint trusts discussed in this special section have several qualities in common. They are designed to help couples:

1. Accomplish some sophisticated estate-planning goals in the simplest possible way.
2. Commingle as much of their property as possible.
3. Take advantage of the opportunity to avoid or minimize estate taxes.

If you would like to review our initial article on this subject but our newsletter somehow disappeared from your coffee table, you can find it on our website, **www.tcvermont.com** in the July 2007 Newsletter.

Basic Joint Trusts

The basic joint trust essentially mimics holding property in joint name. It provides the surviving spouse with complete access to the property held in the trust. Also, it can be a better alternative to simply holding property in joint tenancy. The top three reasons are:

1. Continuity of management, especially in the event of incompetency;
2. Avoidance of probate on the death of the second spouse; and
3. "Stand-by" status waiting for the benefit of minor children.

The cost of maintaining this type of trust after creation can be the same as holding property in joint name. A husband and wife can be co-trustees, and the survivor can serve as sole trustee. During the period that the trust is revocable by either party, the income is taxable to the couple as if the trust did not exist, and a fiduciary tax return does not have to be filed.

Joint-trust planning techniques are generally aimed at married couples, but any two people can utilize the Basic Joint Trust. That is not the case when attempting estate-tax reduction with Disclaimer Joint Trusts, however. Nor is it possible with Tax Plan trusts, which are used when a couple's assets exceed the sum of their estate tax exemption amounts. That is because strategies available to reduce estate taxes on taxable estates navigate with the help of the federal marital deduction. Married couples also avoid the shoals of gift taxes when they combine substantial assets into a single trust.

Because joint trusts intended to reduce estate taxes travel near the imposing cliffs of estate tax laws, they require the planner's careful scrutiny of tax rules. For that reason, we must include technical detail here, but we keep it from obscuring the forest for the trees by utilizing footnotes. We do this in hopes that the technical discussion will not discourage the lay reader from sailing through the text.

The Disclaimer Joint Trust

If a joint trust is drafted in such a way that the value of both the decedent's and survivor's shares are included in the estate of the first spouse to die[1], it is now possible for the surviving spouse to fund a Bypass Trust (also known as a "Credit Shelter Trust" or "Family Trust") by disclaiming all or part of the trust assets, to save federal estate taxes if needed.[2]

The insertion of a clause to allow for this type of tax savings option should be considered even for trusts for married couples whose combined estates fall well below the current exemption of $2 million. It can't hurt. The basic joint trust will initially leave the surviving spouse with complete control. However, if at the time of the first spouse's death it appears desirable to act in order to avoid or reduce federal estate taxes, the survivor can disclaim any or all of the trust assets within nine months following the first spouses' death and yet retain many of the benefits of those assets held in trust.[3]

The benefits of this type of trust can best be illustrated by example. Let's say a retired married couple has $2 million between them – a home worth $300,000 in joint name, $700,000 in securities and an IRA account owned by the husband worth $1,000,000. With the $700,000 in securities held in the joint trust along with the real estate[4], then if Congress keeps the current exemption at $2 million, the survivor will have complete control over the assets in the trust and probably will have no need to disclaim any of the securities. Thus, the husband and wife will have all the benefits of a basic joint trust as outlined above.

However, let's say Congress does not alter the existing law, and in the year 2011 the exemption falls back to $1 million, as will happen if no change is made. Let us also assume that the husband, owning the IRA, dies first, leaving the IRA to the wife as is customary. With that tax landscape in view, the surviving spouse might now elect to disclaim the trust assets of $1 million and roll over the $1 million IRA into one in her own name[5]. In so doing, she shelters the trust's assets from her eventual estate. Her subsequent estate will then consist only of the $1 million IRA, which will be at or below the taxable threshold. That strategic move could save in excess of $400,000 in estate taxes.

The surviving spouse will still be able to continue to serve as trustee of the trust, have access to the income, retain a limited power to appoint assets to children, and have the right to invade principal albeit within the IRS' sanctioned standards, such as for "health, education, support, and maintenance" – all part of the goal of simplifying the estate and providing the survivor with as much discretion and control as possible.

We will continue this discussion in our next issue. In the meantime, if this article piques your interest, feel free to give us a call or consult with your tax advisor.

Chris Chapman, Trust Administration

Attorney Footnotes

by Jack Davidson

[1]The assets will qualify for the marital deduction and will not be subject to the federal estate tax.

[2] This is accomplished by the spouses granting each other a general power of appointment over trust assets, with a testamentary power granted to the first spouse to die, enabled in PLR 200101021, and lifetime power granted to both spouses in PLR 200210051. As a result, the surviving spouse's share is included in the decedent's estate under §2041, with the surviving spouse treated as making a gift which qualifies for the marital deduction of his or her share to the decedent upon death.

[3]The survivor can still have the right to income and principal for "health, education, support, and maintenance" while continuing to serve as trustee, and the resulting trust will pass free of estate taxes. It also should be noted that a disclaimer cannot be made if, during the nine-month period, the survivor receives benefits from the trust. Hence, it is very important that upon the first death the surviving spouse consult with his or her financial advisor before taking a distribution from the trust.

[4]A simple transfer is made by deed, with no federal tax consequences.

[5]If the survivor is the wife, she would probably first roll over the IRA to one of her own and name the children as beneficiaries. A number of related income tax strategies are also available but beyond the scope of this article.

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