Quarterly Update

January 2010

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

Market Reflections

Peter Sherlock, Trust Investment Committee

2009 is now history, and although there is some debate about whether or not we have ended the first decade of the 21st century, it is clear that 2009 is a bookend year to a two-year, 2008-2009 bear-bull market period that investors won't soon forget. From the lows of early March, last year saw one of the strongest nine-month rallies in history, rising some 67% into year-end in the process. It is astounding to think about how well the equity markets have done these last few months, given the well-known problems of rising unemployment, economic malaise, exploding government deficits, rising commodity prices, and a continuing overall decline in the U.S. dollar. It is simply astonishing to look back over the last 12 to 24 months and see how far the market averages declined, and then recovered. The equity price volatility we have seen these last two years, while certainly providing trading opportunities for the nimble (and lucky, we suspect), also validates the importance of a disciplined, consistent approach to equity selection, asset allocation, and portfolio management. In our minds, it confirms the difficulty of consistently predicting and reacting to the markets gyrations in response to day-to-day events, and the risks in attempting to do so when it is so easy to be wrong.

Maybe even more interesting is how the bond markets have fared these last two years. Those who believe that bonds provide safety from price volatility may have to rethink that premise after what we experienced. 2008 saw a tremendous worldwide rush to the safety and liquidity of the U.S. Treasury market, and U.S. Treasuries were essentially the only marketable asset class in the world that provided positive returns in 2008. However, 2009 confirmed that financial markets aren't always as they appear (or as investors hope), and long-term U.S. Treasuries in 2009 generated marked-to-market losses of over 25%. While the liquidity that so many investors seek remained, for many investors, the safety (at least from price volatility) of U.S. Treasuries proved very illusionary. For the rest of the credit markets, like corporate and municipal bonds, their returns reflected mirror images of the U.S. Treasury market; losses in 2008 as investors sold for the safety of Treasuries reversed to strong gains in 2009 as investors regained confidence and desired the higher yields that such vehicles provide. The most telling example are the returns provided in 2009 from so-called "junk bonds" (debt obligations issued by low-quality corporations), which by one measure returned over 58% in 2009, as confidence returned and credit markets healed. Historically, returns in a range of negative 25% to positive 58% make investors think of stock markets, but the last two years have proved that price volatility exists everywhere in the financial world.

What is next for the economy, the stock market, and the bond market? Well, of course no one really knows for sure, so one has to be careful about making investment decisions based upon predictions. However, we do know that equity markets, from an overall historical valuation perspective, are neither particularly cheap nor particularly overpriced. If the economy continues on the recovery path that it may be currently on, then growing corporate earnings can lead the stock market higher. If, however, the economy stumbles, than it is hard to see how equities show continued price increases in the short run. However, to hope or plan on returns in the next nine months from the stock market that are similar to the last nine months would be foolhardy, at best. It could happen, but it wouldn't be a bet one should make. The bond market is of course a reflection of interest rates, and here there is an interesting dilemma. The Federal Reserve is keeping short-term interest rates at historically unprecedented lows, as it provides enormous amounts of liquidity to help stimulate the recovery. So while short-term interest rates are providing essentially no returns on invested capital, similar actions by the Federal Reserve in the past, and as well as by other central banks worldwide, have ultimately led to rising levels of inflation and interest rates, both highly detrimental to longer-term fixed-income investors. While we can't predict which way interest rates will go in the short-term, we can try to limit the potential damage that such a rising interest and inflation rate environment would create on a fixed-income portfolio. We'll attempt to do just that by keeping our overall, weighted-average fixed-income investment maturities relatively short term, giving up modest incremental income in order to endeavor to preserve ultimate capital purchasing power.

A Preliminary Planning Checklist for 2010

What we know:

Vermont Capital Gains Tax: Vermont allows for a 40% capital gains tax exclusion for taxpayers 70 and older through the year 2010. For joint filers, only one filer needs to be 70 or older. The tax savings may not be enough to warrant a sale for this reason alone.

IRA to Roth IRA Conversions: Starting in 2010, taxpayers with modified adjusted gross income of more than $100,000 will be allowed to convert a traditional IRA to a Roth IRA. This change applies to all years beyond 2010 - and the income taxes due on the 2010 conversion can be spread over two years. Whether to convert or not may require some sophisticated calculations. In this connection, if you have a potential estate tax you probably should take into account the benefit of converting now and, in effect deducting the tax, which "deduction" would be otherwise unavailable for inherited IRA's.

What we don't know:

The Federal Estate Tax: Of course if you are going to factor in the estate tax we might want to know what the federal estate tax is and, at the time of this writing, this is uncertain. Technically, we now have an unlimited exemption but it is anticipated that this will change retroactive to January 1, 2010.

The De-Coupled Vermont Estate Tax: The tax planning strategies to avoid or minimize this tax are still in development. For those who reside part-time in Vermont and avoid Vermont income tax by staying out of the state six months and a day, you may still be a Vermont domiciliary for purposes of the estate tax. The test of principal residence for estate tax purposes will be determined by Vermont and, thanks to an old US Supreme Court case, they will have the principal say, not the jurisdiction where you think you maintain your principal residence. It is unclear what standards the State will use. Talk to your lawyer.

If your principal residence is not Vermont, and you own real estate in Vermont, you may still be subject to a prorated Vermont estate tax on the value of the Vermont real estate. You may want to consider some other form of ownership, such as a family-owned LLC, thus converting the real estate into intangible property instead. Talk to your lawyer.

In Memoriam

On October 9, 2009, Joseph Constance Senior, passed away. "Joe" was a founding director of the Trust Company of Vermont. We are deeply indebted to his help in the creation of our company and his ongoing contributions. We valued his experience and intelligence, integrity and warmth, and he will be sorely missed. So to Joe, "You will always be remembered on the first tee".

The Brain & Retirement Planning 101

Jack Davidson

This article was supposed to be about Medicare and the choices we have when we retire. Unfortunately, I discovered that my brain was not up to the task. So I became distracted and started concentrating on matters of the brain and retirement itself.

How the brain functions as we age is very important to me for personal and professional reasons. As I get older, how will I function at work? More importantly, as the company gets older, how will it function at work?

Thanks to Google, I can become an "expert" on the brain within a day. I don't need to spend countless hours in the library to find out about the latest research if, in fact, the library has it. I simply need to sit here at my computer and follow links. And sit I do.

Unfortunately, I just found out that exercise is important to maintaining a healthy brain. But wait, I just found out that a team of scientists at the University of California just reported that new Internet users between the ages of 55 and 78 improved their scores on decision-making and complex reasoning tests after just seven days online. So, maybe I need to run with my Blackberry?

And I just found out that I won't need to blame my brain for declining memory because the culprit is actually my weakening ability to filter out distraction, according to the findings of UC Berkeley neurologists. So, if I think my memory is declining, I simply need to find quieter surroundings since distraction is bad. Perhaps I should even avoid Google?

But wait, I just found out that distraction is good. A recent study found that seemingly irrelevant data, which younger testees ignored, distracts older people. Although distraction makes us slower, the hypothesis of the study was that it made us smarter because we don't ignore data. We are wiser. There is a reason why the Fortune 500 companies are not run by bright 20 year-olds.

But wait. Are we wiser? Maybe the bright 20 year-olds simply went to work for Goldman, invented and sold new investment products that they then bet against and retired at age 35......oops, I stereotyped. I should be wiser than that.

Or should I? I just found out that, as a result of a recent study, some psychologists are proposing that older people may exhibit greater prejudice because they have difficulty inhibiting the stereotypes that regularly get activated in all of our brains. They suggested an aging brain is not as effective in suppressing unwanted information - including stereotypes.

But, we are happier? I just found out that recent studies show older people aren't as motivated to recall the negative and that we are much better at screening it out than our younger counterparts. But then again, maybe we have more negatives to screen out?

This is getting confusing. So, perhaps I should simply concentrate on what I have observed over the years, knowing full well that I screen out the unpleasant and that, as I age, I become more prone to stereotyping people and events. Some observations:

Card Players. I believe card players tend to maintain their mental acumen - particularly bridge players. I remember a conversation with Gertrude Croker who, at age 113, was as sharp as a 20 year-old. A very smart 20 year-old. She excelled at bridge as did so many of my clients who showed no diminishment of their mental faculties. If only I had listened to my mother and learned how to play bridge. Liar's Poker doesn't count.

There is no set age for loss of productivity. People don't simply change at age 65. I used to work with Russell Ellis, who at the time he joined us at the Vermont National Bank Trust department was age 58. I was 32. He worked harder and smarter than me, and when he finally responded to his wife's urging that he retire at age 70 I had not caught up to him. Probably still haven't.

Some things are better with age. Next year, Warren Buffet will turn 80. Quoting Warren, "There are three kinds of people in the world: those who can count, and those who can't." It is my opinion that if Warren makes it to 113, he will still be better at math and investing than the vast multitude of investment managers. Incidentally, Warren is an avid bridge player, but I am not sure how well he would have fared against Gertrude.

A mind is too important to waste. It is probably coincidental, but I have recently met several individuals in their 80's who are excelling intellectually. They are using the currently available technologies to remain vital and productive. I think that the internet is in the process of revolutionizing retirement, and we will all be the better for it.

Craftsmen seem to survive retirement better then executives. I think losing power as we age is inevitable. If prior to our retirement we functioned in an environment where we were valued in how we exercised power, we might be ill-equipped for the process of losing it. In contrast, I have observed that individuals with very specific skills who downsized but continued their craft into retirement tended to fare quite well.

Get ready for retirement. Now I know this is anecdotal but I kind of think that many couples approaching retirement don't spend much time talking and planning for it. I think discussions between spouses should start early and often. Spousal interface may be problematic when he or she discovers somewhat late in the game that you have no plans to retire.

If married, focus on your spouse. Many psychologists feel that there are three stages of stress in a marriage. The third stage is generally around retirement age because it is at this stage that the chit of companionship is called in. If you have a spouse who delayed taking the trip to Europe because you were always busy at work, take the trip when you retire whether you want to or not. Go to the play and pretend to enjoy it. Honor the unwritten agreement.

If you are a male, start reading magazines for women. You will find an abundance of articles discussing the challenges couples face when the husband retires and attempts to take over the management of the household and his spouse.

Golf will probably not be enough. Your handicap may initially drop, but so will your driving distance. Then, one day your handicap will start moving up, then you start using the golf cart, and then you face moving to the senior tees. It isn't pretty.

Meeting People. When you meet someone and, because you can't remember their name, you are reluctant to introduce your spouse, do what I do. My wife quickly moves forward and says " Hi, I am Judy, Jack's wife, and your name?". Otherwise who knows what rumors may fly. Also take comfort, when meeting someone who you haven't seen for awhile and they heartily greet you with your name and you cannot remember theirs, they are just showing off. It's better to be appropriately aged than a showoff.

Medicare. If you don't understand it, if you just want to be told what to do or to delegate it to your spouse, and you grow frustrated, angry, ugly and depressed; if you have some or all of these reactions, well take heart. It means you are young. Only the young could feel this strongly and hold onto these negative thoughts.

The Trust Company of Vermont is another year older.

We have been in business for ten years, and we are all still here. Ten years from now, we hope to be able to make the same statement. We don't want anyone to retire who doesn't want to retire. Thus, we have a simple plan: part-time retirement. If one of us wants to work 80 %, we'll cover. If 50%, we will hire a younger person for him or her to mentor and who will pick up the slack. Our goal is to have a staff that has a combination of energy, creativity, experience, and wisdom. We also promise to write everything down.