



# Quarterly Update

October  
2010

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

## All That Glitters

One of the first books on investing that I read in college was *Stocks for the Long Run* written by Wharton Business School professor Jeremy Siegel. In the first chapter of the book, Siegel explores historical asset class returns. Making adjustments for inflation, \$1 invested in gold bullion in 1802 was worth \$.98 in 2001. This compares rather unfavorably to stocks, given that \$1 invested in stocks in 1801 was worth \$599,605 in 2001. This led Siegel to conclude that “in the long run, gold offers investors some protection against inflation but little else. Whatever hedging property precious metals possess, these assets will exert a considerable drag on the return of a long-term investor’s portfolio”.



Since 2001 however, gold has been a top performing asset class. Over the past ten years, gold investors have made almost five times their money while the S&P 500 has been relatively flat. As a result of this phenomenal performance, clients have asked questions about gold and whether it would be a suitable investment. While I am not going to give a prediction for where I think gold prices will be one week or one year from now, I will attempt to answer some common questions being asked by clients.

### *Why has gold performed so well recently?*

As an asset class, gold is viewed as a hedge against inflation and financial stress. Gold tends to perform well during periods of financial, economic and/or political turmoil. The confluence of a global recession, political unrest in certain parts of the world and currency fears over government deficit levels has led to an ideal environment for gold investors.

### *Is gold a safer investment than buying stocks?*

Although gold is considered a store of value, to say that buying gold is less risky than buying stocks would probably be

a mistake. While you may be hedged from the purchasing power risks associated with currencies, gold, like equities, can be prone to dramatic swings in price. From 1979 to 1980, the average price of gold increased 101%. From 1980 to 1981, the average price of gold fell 25%.

### *Will gold continue to out-perform equities?*

If the next few years are characterized by economic or political stress, inflationary fears and currency devaluation, gold should continue to perform well. From 1970 to 1980, a period characterized by political/financial stress and inflationary fears, the average price of gold increased more than tenfold.

However, it would be wrong to assume that gold will out-perform equities indefinitely. From 1980 to 2000, gold lost approximately 80% of its purchasing power, while the S&P 500 experienced phenomenal gains.

~ Chris Cassidy, Trust Investment Committee

## Alert to our Online Users

At the end of October we will be converting our trust operations system. This will mean online access will not be available from November 1st to November 10th. Please accept our sincere apologies and our assurances that the new system will be worth the interruption. Our online users will be receiving detailed information from Debbie Brown and, in the interim, if you have any questions please don't hesitate to contact her at 802- 367-1200.



# THINKING INSIDE THE BOX

Jack Davidson

We designed our trust company to manage assets for successive generations. As a result, our relationships tend to have life cycles. We start with investment management accounts that become revocable living trusts and, in time, evolve into irrevocable trusts.

Our Company has been in business for eleven years and we can see the transformation of our relationships as we age and our clients age. In our early years, almost all our accounts were focused on the straightforward management of assets. Now we have almost 300 irrevocable trusts where the focus has shifted to the trust administration of assets with the added dimension of caring for spouses and children.

Our Company is somewhat evenly divided between trust administrators and investment managers. The two groups have different personalities and this is the way we like it. We want our managers to be divergent thinkers and we want our administrators to be convergent thinkers. In short, we want our investment managers to think outside the box (not very far outside the box, mind you), and our administrators to think inside the box.

Why is it so important for our administrators to think inside the box? It's the nature of their duties. When an investment management account turns into an irrevocable trust an entire infrastructure kicks in. Principal and income accounting becomes very important and the trust will, in most cases, be subject to complex fiduciary income tax rules and filing requirements. And now the trained administrator steps in, ready to deal with the details that many of us would prefer to avoid. And in many cases they are about to become a substitute parent, a job for which they are well-suited.

Trusts are ruled by boxes, and boxes tell us how to behave and distribute our clients' assets. Trusts, as legal documents, need to be designed so that we know our clients' intents, and, under the law, we are not ordinarily



"Never, ever, think outside the box."

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allowed to guess the intent or look beyond the confines of the document itself. In short, we are usually required to keep our blinders on and disregard "That's what Daddy would want" when the trust does not appear to support a proposed course of action.

The boxes that we most often deal with are the ones that tell us, as trustee, when to invade principal (i.e., when we should consider paying out more than the income from the trust). Some of these boxes are heavily influenced by the tax savings objectives. Others are influenced by none other than our role of *In Loco Parentis*.

There are two types of boxes we most often encounter: the spousal box and the box for children. Here then, are some thoughts for our clients:

## THE SPOUSAL BOX

The spousal trust is ordinarily designed to save estate taxes, so the language used for invading principal

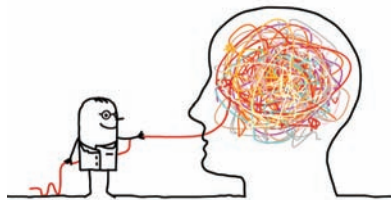
tends to look like this: “My trustee shall invade principal for my spouse for health, education, support and maintenance.” We call this “IRS-sanctioned ascertainable standards,” and this means that if you use this language the surviving spouse can be trustee without adverse tax consequences. If you want less restrictive language, a disinterested trustee such as the Trust Company of Vermont may be needed.

Whether you should consider using your spouse as trustee of your trust for his or her benefit after you are gone depends on whether he or she will stay inside the box and is adequately protected by an infrastructure (see next page) that will provide informed guidance as to the parameters. I am reminded of a story about an acquaintance who was designated trustee of her spouse’s tax savings trust. She called her broker and said she needed \$100,000 to simply add to her checking account. He sent it to her, no questions asked, even though he knew the purpose of the trust. Absent a process of substantiating and documenting compliance with the principal invasion clause, this transaction was a violation of her fiduciary duties, which may have a negative impact in the future. The IRS does not like you stepping out of the box. And in some instances, neither will the recipients of the trust, upon termination.

## THE BOX FOR CHILDREN

“*In Loco Parentis*” takes me back to college when a shift occurred to control my behavior. The College was now my parent. We have many trusts where we act in a similar capacity. And now the box becomes very important.

Estate planning can be daunting. Sometimes in the process one can get distracted and not focus on the boxes for children or others whom we need to care for until they are able to handle their own finances. For some children, this may be a challenge that will last a lifetime. To be sure, we have a number of trusts for children where the principal objective is tax savings, and the invasion clauses are designed primarily



to accomplish this objective. Those boxes tend not to be customized. One of the challenges in estate planning is to customize the boxes when a trust is necessary for children for non-tax reasons.



In our July 2010 newsletter we expressed our *per stirpes* preference. That is, we favor treating all the children the same in terms of how much of your estate they will receive. That said, we think that some children’s shares should be held in trust and others should be paid outright, depending on the needs, capacity, personality, circumstances and all those other factors that you would consider were you still alive.

You can have principal invasion standards that are very broad. If you do, don’t have a single fund for all the children, or have a way to adjust shares for a principal invasion that favors one child over another. Without standards it is very hard for the trustee to invade principal for one child knowing that the other children’s share will be reduced proportionately.

When designing the principal invasion box, here are a few things to think about: should you include standards related to health, education, support and maintenance; support for spouses; support for grandchildren; principal to buy a home or start a business, to name a few?

If you decide that you would like one of the siblings to act as trustee, just be mindful that if this responsibility puts the child in an awkward position, you may want to consider a disinterested co-trustee who can make the invasion decision alone if so authorized. The important thing is to take time to think into the future in designing the box. This box may have a profound effect on your future generations.

## THE TRUST COMMITTEE

When we receive a request to invade principal or increase a discretionary income distribution above \$1,500, the administrator brings the request to a committee. Last year the Committee deliberated 53 times.



Why a committee? It is our experience that we need multiple personality types to make the best decision.

To be sure, the meeting is dominated by the convergent thinkers, but we also have at least one divergent thinker present. Sometimes we need to spend time exploring the parameters. I think often of a request from a 33-year old beneficiary for funds to provide for a house down payment. A reasonable request from a responsible person but the trust only provided for a distribution to her when she was 35 and did not authorize us to invade principal. We loaned her the down payment and gave her the note when she turned 35. A divergent thinker found authority for us to make a personal loan. Sometimes boxes can be larger than they first appear ~ but they are boxes nonetheless. That's why it's good to think about the trustee's discretion to act when you are not around.

## TRUST INFRASTRUCTURE

If one uses family or friends as trustees of irrevocable trusts they should have a support network. This network should include investment managers familiar with fiduciary obligations, individuals knowledgeable in fiduciary accounting and fiduciary tax accounting (they are not the same) as well as fiduciary tax preparation, and perhaps a lawyer on call. They also will need to use a transaction accounting system that will separate receipts and disbursements into columns marked principal or income.



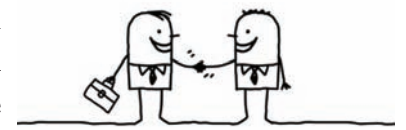
The Trust Company of Vermont furnishes such a service and we have seen a growing trend to use family members as trustees. Whereas years ago we would be trustee of almost all our irrevocable trusts, now approximately a third are accounts where we simply furnish the infrastructure.

## BREAKING THE BOX

Sometimes a trust will neglect to include important provisions. I am reminded of an instance at the Vermont National Bank Trust Department concerning two trust officers and a trust with a very big hole in it. Years

ago, bank trust departments often agreed to act as trustee for very small trusts and some of these trusts, drafted before the word processor, were models of brevity. The bank was administering one such trust set up by a retired school teacher for the educational benefit of a promising student. The trust provided for distributions to pay for the student's college education. The trust did not address the possibility that the student would not go on to college nor did it provide for a termination date or remainder beneficiaries. The student left high school, went into the service, and upon his return applied to the bank trustee for funds to go to a TV repair school. The trust officer ~ let's call him "Bill" ~ was new and knew only how to deny with a perfunctory "No, doesn't meet the standard."

He never heard from the student again. More than twenty years passed. Then one day Bill noticed the trust, and by this time understood that a "No" should be accompanied by a guide ~ not simply denied. So he turned to a colleague and asked if she could help find the student, now well past his college years. "Sue" hired a detective agency and found him one town over. The student had not gone to college and was a tradesman. Knowing this, Bill suggested that Sue call and find out if he had children in college. If so, she could volunteer the trust assets even though the trust did not specifically authorize this expenditure. The trust was simply too small to afford the costs of court authorization. Sue called. The man had gone to bed literally the night before, praying that he could find a way to afford college for his daughter. Sue and Bill broke the box. The daughter went to college. Sue took the credit and the "denied" beneficiary still hates Bill. But Bill feels better now.



In Vermont there is an active group of trust officers and attorneys working to modernize our trust law. Recently this group was responsible for passage of the new Vermont Trust Code ("VTC"). The VTC has many important parts to it, including the ability of the Probate Court to modify all trusts that need to be updated. Some of us in the trust field find the above story, although true and perhaps heart-warming, somewhat troubling in that trust officers shouldn't be filling in the blanks. If a box needs to be changed or added, we now have a speedy and inexpensive way to do it. Our own Christopher Chapman is part of this group and in our next issue he will be discussing some of the most recent changes.