Trust Company *of* Vermont
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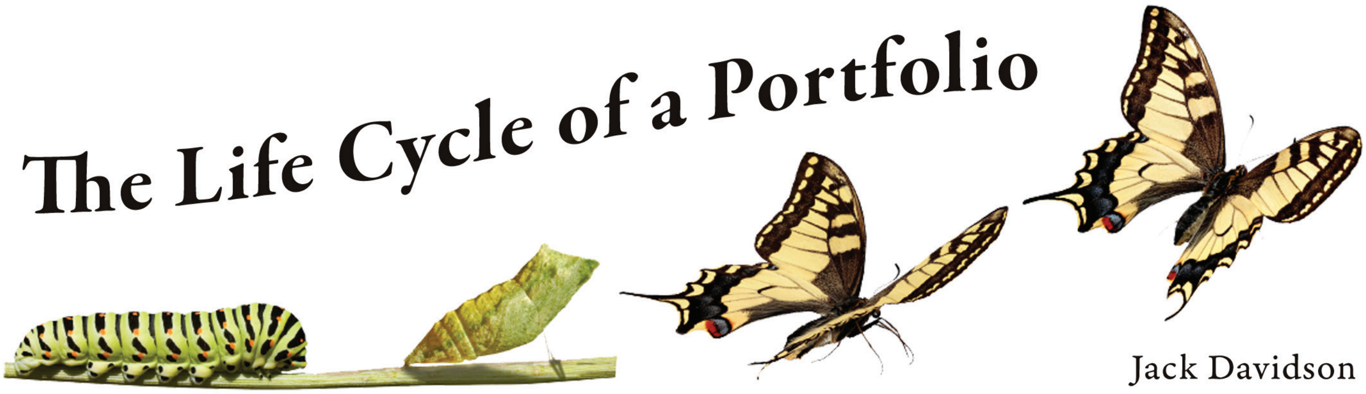
The Life Cycle of a Portfolio



Jack Davidson

The Trust Company of Vermont is structured to invest assets over our clients' life spans. The cycle often starts with IRAs and investment management accounts and is followed by revocable living trusts. The cycle is completed with Irrevocable Trusts, which are primarily designed for tax savings, or to serve the needs of the next generation, or both.

Each of our investment managers' primary goal is to focus on the risk/reward profile for every client. Asset allocation is their principal tool. Asset allocation is layered from the simple to the complex, but for the purposes of this article, the simplest and perhaps most powerful component is the percentage held in equities.

We build life-cycle portfolios, not fear-cycle portfolios. If the manager and the client are able to share the long-term benefits of the life-cycle portfolio, they will avoid the temptation to overload in equities when the market is doing well and discard them when the market is in decline.

The primary focus of the life-cycle portfolio is the age of the client. For years, the accepted wisdom was to subtract your age from 100 to get the percentage of assets that should go into equities. But the conventional wisdom ebbed and flowed. In the 90's, 120 became the norm for many managers.

In the broader investment community, life cycle portfolios may look like this for a client with substantial income potential or resources:

- If you're under 40, 90 percent stock portfolio;
- Between ages 40 and 60, 80-20 stock-bond ratio;
- Between age 60 and retirement, shift to 60 percent, and in most cases closer to 70 percent, in stocks.

Fidelity Freedom Fund would cap equity at 50 percent.

The point of life-cycle portfolio management is to emphasize stocks when we have plenty of time to recover from setbacks, and reduce the percentage as we age when preserving capital becomes a higher priority.

Our managers should adjust the allocation percentages as our clients age.[1] They can also consider a lower equity ratio strategically; for example, in advance of a market decline. As the risk manager for our company, I sometimes monitor the equity percentages. As I consider the life cycle, I would expect that the equity percentage would decline in sync with age. Does it happen? Well, yes and no.

Capital gains and client loyalty to inherited, long-held, "legacy" stocks frequently account for a higher equity percentage. We are not a formula-driven company, however. Customization is a problem for risk managers, and we would love to have one size fit all. Not so with our managers.

Sometimes we encounter clients who have been brought up to believe that they should only spend income from their portfolios. In the old days, when dividend and interest rates were higher, that strategy might have worked pretty well. Not so now. Overall, dividend policy changed many years ago; and interest rates are at a historic low. If a client is retired, we should be promoting the 4-percent rule. We are not likely to exhaust a fund using that strategy. The essence is, don't live on the income, but take 4 percent of the value in monthly installments. This way, our managers will not have to worry about shifting to safer Treasury securities and dramatically reducing income thereby. Of course, if you don't need the money, we will not worry about your monthly checks, and we will be able to manage the portfolio "naturally," i.e., without having to skew investments one way or another to accommodate income needs.

There is one problem in life-cycle portfolio management that we face on a regular basis. It is a problem that many in the investment community are simply not equipped to handle, and many practitioners are not even aware of the problem. It is what I call the "unnatural" management of irrevocable trusts. When we manage assets in an irrevocable trust, we have to manage the income for the income beneficiary and the principal for the remainder parties. We have a duty to serve both classes of beneficiaries.

I recently polled our managers. I asked them what would be, in their opinion, the ideal equity ratio over a 20-year cycle for the best overall return. I then asked them whether they would change the equity percentage if the trust were required to pay out all the income. They changed their percentages when answering the second question.

If a manager, in anticipation of a market decline, shifts a greater percentage to Treasuries, those assets, which are paying at historically low interest rates, may wreak havoc with the income distribution. [2] A few years ago, while with the Vermont National Bank, I encountered an income beneficiary who was not related to the remaindermen. She wondered whether we had mismanaged her trust. During our stewardship, which was when interest rates had begun their long-term decline, her income had gradually halved. Where did the money go? Well, when the bonds yielding 12 percent had matured, we could only find 6-percent bonds to replace them. Yet the portfolio had doubled in size, thanks to a strong stock market.

In determining the life-cycle of an irrevocable trust, we should estimate the life expectancy of the income beneficiary or beneficiaries and the duration of the trust. In the past, we were confined by fiduciary law that had not kept up to date with the expected income returns. I have seen trusts drafted when 10-year government bonds seemed to have a reliable yield of 8 percent (not to be confused with the brief period in which we could get 20-year non-callable government securities at 16 percent), and I suspected that it influenced both the donor's and the drafting attorney's judgment. A distribution clause restricted to income may have seemed adequate at the time. Fortunately, our legislators have recently adopted new laws that address this problem. For example, we may now be able to convert an income trust to my favorite, a 4-percent trust.(For many trusts, the law allows us to convert an income trust to a uni-trust and set the income rate up to 5 percent).

In future issues, our in-house expert regarding the changes, Chris Chapman, will provide additional guidance. In the meantime, if you are, or know, an income beneficiary who is unhappy with the income flow, call us.

1. *That said, we should revise our formulas on a case by case basis. Many of our 65 year old clients now speed walk, run and bike. We should adjust their age. A 70-year-old man, for example, could expect to live anywhere from seven to 23 years. A 70-year-old woman would likely to live another 10 to 30 years. A recent study concluded that the faster they walked, the more likely they were to land on the longer-living end of the spectrum.*

2. *Currently the price of safety (buying bonds) is minimal return - and likely negative return on an inflation-adjusted basis. These days, bonds may indeed be a risk investment without a return as compared to the past, when they were viewed as modest-returns, no-risk investments.*