Trust Company of Vermont

Quarterly Update

July 2010

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

"Past Performance" Perils

David DeBellis, Trust Investment Committee

The phrase "past performance is not an indicator of future outcomes" is a common fine print line found in all mutual fund literature. Yet even after dozens of studies that confirm it to the contrary, investors consider past performance to be one of the most important factors in selecting a mutual fund.

At some point in their careers, almost every top-performing mutual fund manager underperforms their benchmark and their peers, especially over time periods of 3 years or less. One study looked at a group of more than 1,300 mutual funds with a 10-year performance record as of December 31, 2007. This group was narrowed down to the 505 funds that exceeded their benchmark by one percent or more on an annual basis for the 10-year period. The average manager in this group exceeded the benchmark by more than 3 percentage points and the top quartile managers outperformed by more than 5 percentage points for the time period.

Despite their impressive long-term track record, almost all of these managers underperformed at some point during the 10 year period. Over 80% of the top managers had at least one three-year period in which they underperformed by one percent or more. More than half of them lagged their benchmark by more than three percentage points and a third of them underperformed their target by five percent or more.

So depending on what time period they looked at, investors may not have selected any of these managers, even though they were the best for the longer time period. Unfortunately, even though mutual funds typically report performance for one, three, five and 10-year time periods, many investors take action based on the one and three year numbers and thus begin a period of chasing performance. By doing this, they violate one of the most basic tenets of investing: buy low and sell high.

So why is persistent outperformance so hard to achieve? Some of the reasons for this include investment style of the manager, the market environment and the departure of a key manager.

Another reason for the lack of persistence has more to do with human behavior than anything else. The first question to ask is, "Who gets money to manage?" Investors will want to put their money with the manager that has the best performance. Eventually, this manager will get so much money that it will impact his ability to generate superior returns and his expected return will regress to a point where investors become indifferent and look elsewhere to place their funds.

Picking stocks that will outperform is a difficult undertaking, but it is almost impossible to express how difficult it is to identify top-performing fund managers in time to profit by investing with them. By identifying their specific investment needs and finding a manager that can meet those needs over a long time horizon, investors may reap the rewards of their patience.

Sailing in a Secular Bear Market

Jack Davidson

I can't sail. Perhaps it's because my family had no tradition of sailing. In my youth, summers were spent by occasionally going to Jones Beach and getting a sunburn that qualified as third-degree.

It may be that sailing simply takes too much patience. I am also not an investment manager. I see a trait in sailors and investment managers that I admire. Both can tack. They have learned that sometimes the fastest way to cross the finish line is to select the slowest route. That's how I feel we are today in our management of bonds. Our managers regard yield much as sailors deal with breezes. Do we head to where there is virtually no breeze and perhaps avoid the seductive winds that take us off course?

The managers know that today's low bond yields will increase sooner or later. That's a given to them. So, staying short in high quality holdings is part of a strategy of getting the best return in the long term. Our course is measured over a decade, not a year. Sometimes the managers feel a need to do something more; maybe take a little more risk. How can we earn our keep by purchasing short-term bonds that have almost no yield? I sometimes feel a need to remind them that we want to cross the finish line with the lead boats.

Our managers need to be busy on the stock side, too, and especially agile in equity selection. That doesn't mean we should abandon our buy-and-hold philosophy of quality holdings. It does mean that we should be mindful of diversification. Diversification requires agility, and by that I mean proper diversification, not over-diversification. Were we in a secular bull market, we could simply ride the S&P ~ but we are not. The debate right now is not whether we are in a secular bear market. It is more about when it started. Did it start in 2000 or 2008? The starting date is important to some of us because *secular* bear markets run in very long cycles, unlike *cyclical* bear markets, which tend to average between two and ten months. The last secular bear market lasted sixteen years.

Whether we are right or we are wrong about the secular bear market, our strategy of appropriate diversification should work in all types of markets. We plan on doing this with a combination of individual stocks (30 to 35 holdings) and electronically traded funds (ETFs). And we will monitor the diversification. We do not want to mimic the S&P 500. The following chart illustrates the risk of doing so:

	Annualized Return	
Time Period:	1966-1981	1982-1999
Type of Market:	Secular Bear	Secular Bull
Length in Years:	16 Years	18 Years
Annualized Returns by Asset Class:		
S & P 500	6.00%	18.50%
Small Cap Value	14.80%	18.40%
Small Cap Growth	10.50%	13.70%
Large Cap Value	11.00%	17.40%
Large Cap Growth	5.10%	17.70%
Long Term Govt Bonds	2.50%	12.20%
Long Term Corp Bonds	2.90%	12.00%
30 Day T Bill	6.80%	6.20%
Inflation Index	7.00%	3.30%

Our principal focus will be stock selection and asset allocation. And, as always, it will be with a long-term view. We plan on being with the lead boats. That said, the 1966-1982 secular bear market included eight rallies that ranged from 16% to 76%. So we also expect a bumpy ride, but if history holds true we would like to assure our clients that they will not need a life preserver; Dramamine, on the other hand....................

The Merits of Limited Diversification

Diversification is a concept that everyone in the financial industry preaches as a way to minimize risk. At Trust Company of Vermont, we also emphasize the need for diversification and risk management. However, many clients have been asking questions such as: What is the appropriate level of diversification? Is there such a thing as too much diversification? Are there really any benefits to diversification?

Traditionally, financial theorists have looked at two different types of investment risk: systemic risk and non-systemic risk. Systemic risk is the risk of adverse stock market movements, and cannot be eliminated. Basically, if you decide to invest in stocks there is always the possibility that the broad market will be volatile, or perform poorly. Non-systemic risk is company-specific risk, and can be greatly reduced by investing in a diversified portfolio of stocks. Essentially, the greater number of stocks in a portfolio, the less affected an investor will be if one of those stocks has problems (profit erosion, bankruptcy, etc.)

In the book *Modern Portfolio Theory and Investment Analysis*, written by Edwin J. Elton and Martin J. Gruber, the authors explore standard deviation (a common measure of volatility/risk) and investment portfolios. They start with a very non-diversified portfolio of just one stock. They then add additional stocks to the portfolio, measuring changes in portfolio standard deviation. Elton and Gruber determined that adding 20 to 25 stocks to the one-stock portfolio reduced non-systemic (company specific) risk significantly. The diversification benefits were tremendous. However, the benefits of adding additional stocks to the 20-25 stock portfolio were minimal. Essentially, they concluded that the non-systemic risk of a 1,000 stock portfolio is not much lower than the non-systemic risk of a 25 stock portfolio.

The most famous investor in the world, Warren Buffett, once said: "wide diversification is only required when investors do not understand what they are doing." This does not mean that Warren Buffett maintains a one-stock portfolio, but rather that he would not buy a lot of stocks for the sole purpose of adding diversification. Buffett has been a long-time proponent of only buying companies that he truly understands, and Buffett's investment vehicle, Berkshire Hathaway, has a $51 billion stock portfolio comprised of just 36 common stocks. It is a lot easier to truly understand the stocks that you own when you only own 36 stocks, and when many of them have been in the portfolio for years.

At Trust Company of Vermont we typically manage equity portfolios of 30 to 35 common stocks. It is our belief that this provides adequate diversification, but does not over-diversify our clients. Managing portfolios of this size allows our managers to truly understand the companies that we own and to follow their reports closely.

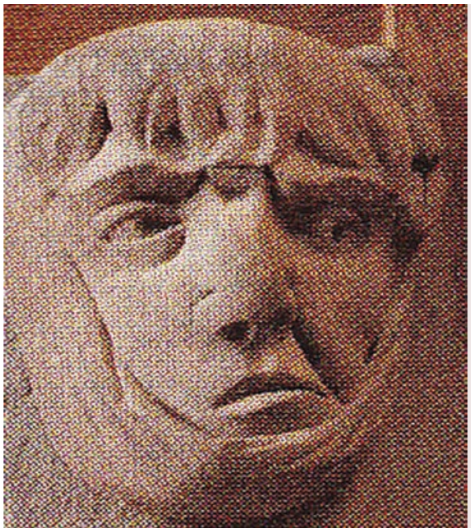
~ *Chris Cassidy, Trust Investment Committee*

Why We Don't Offer "Manager of Managers"

Some of us at TCV were involved in setting up a Manager of Managers program at Vermont National Bank whereby we managed a portfolio of no-load mutual funds. We started the program in the early eighties well before it became popular. We ran this program side-by-side with the more popular stock selection program consisting of approximately 10 to 20 individual equities as part of our traditional investment management services.

When we started TCV, we decided not to continue the Manager of Managers program. As David points out in his article on the perils of past performance, managing managers is not an easy task and we simply did not experience better performance. Furthermore, it was harder to control diversification. We chose instead to achieve and control our diversification by building a portfolio of 30 to 35 individual common stocks supplemented with specialized funds, usually electronically traded funds (rather than costlier mutual funds), to achieve better diversification.

One caveat about a Manager of Managers program ~ frequently those who sell this type of service will only tell you their own fees and not the underlying expenses of the mutual fund managers. More importantly, they will tell you the past performance of the funds currently populating their portfolio and not the actual performance of the program. Almost invariably this will show "hypothetical" numbers that are higher then the actual experience of clients in the program.



Word Processors, Estate Planning and the Impact of Modernism

Jack Davidson

If you were a stonecutter in the 1870's in New York you were probably an immigrant of English, Scottish, Irish, Italian or German extraction. You also stopped and took a break from your work at about 10 am to have a bucket of beer. Architects at the time would frequently note on their plans simply where an ornamentation on the facade of a brownstone should appear, and they left it to these same highly skilled stonecutters to design and carve the embellishment. Perhaps sometimes fueled by the bucket of beer, these stonecutters frequently sculpted eccentric figures such as portraits of friends with bandaged faces or a man thumbing his nose at his neighbors.

After reading about the efforts of Ivan Karp, art dealer and collector, to save these nineteenth-century American ornamenti, I keep thinking about how much estate planning has changed since my arrival in Vermont in 1970.

I view attorneys who draft wills and trusts as architects. But in those days there were a fair number of stonecutters as well. Wills could be fun to read and many had personalities. Alas, like New York architecture, we went from Victorian adornment to modernism of glass and steel pretty much overnight. I believe the rapid transition was caused by the word processor, which then enabled the widespread use of form books.

In 1971 I accompanied a client to see his attorney in Chester, Vermont. I expected a routine will signing, a timely return to Brattleboro and dinner at home. "Have you read the Will?" asked the attorney. "Yes. You left out my middle initial", said the client. "Well, my secretary is here and she will retype the Will" responded the attorney. So much for a timely return to Brattleboro. Thus was the world of estate planning before the word processor.

Form books ~ that is, a collection of well-drafted trusts and wills ~ were readily available then. In fact, we started distributing the Northern Trust form book to Vermont attorneys during the early 70's. However, word processors were not. You could buy an IBM Display Writer for $12,000, but that was more than what many Vermont attorneys made in a year.

Those attorneys who could afford a row of secretaries tended to use form books. They were also the ones who handled clients needing tax planning, that is, estates valued above the federal exemption of $60,000, which represented approximately 5% of Vermont estates at the time. The rest seemed to rely on documents that they had cobbled together over the years, perhaps under the belief that less is more.

Wills and trusts were understandably shorter then. They seemed more personal as well. Perhaps the customization was more evident simply because the multiple pages of boilerplate language had not yet arrived to hide the few paragraphs that actually disposed of property. Or perhaps our legal documents are now almost exclusively the creation of the architect embracing modernism, and we simply have fewer stonecutters practicing law. We no longer seem to find interesting clauses like the famous "To my cousin Ralph, whom I promised to remember in my Will, Hi Ralph".

At the Trust Company of Vermont, we don't prepare wills or trusts. We review them. Our clients select their own attorneys and our role is to assist in the process of designing plans that meet their objectives. We also work in the background with the attorney and provide forms and suggested language, if needed. Most of the attorneys in Vermont who specialize in estate planning have developed their own forms using well-designed form books as their guide. So now, for the most part, we focus on the customization of the form and the translation of the plan to the client.

Our clients frequently ask why it was necessary for the attorney to produce a 40-page trust. Much of the language found in a trust is to cover contingencies that have been time-tested but are unlikely to be needed. Now that the language is easy to produce with our word processors, why not use it?

Regardless of the length of the document, we tend to find, on average, less than two pages that require our attention. Our focus is usually on the tax-oriented marital deduction clauses and the provisions for distribution to family members. It is in these two areas where the benefits and drawbacks of the computer-generated form are most evident. Form books tend to have biases, and frequently the sheer volume of words hide the stress points where important decisions need to be made.

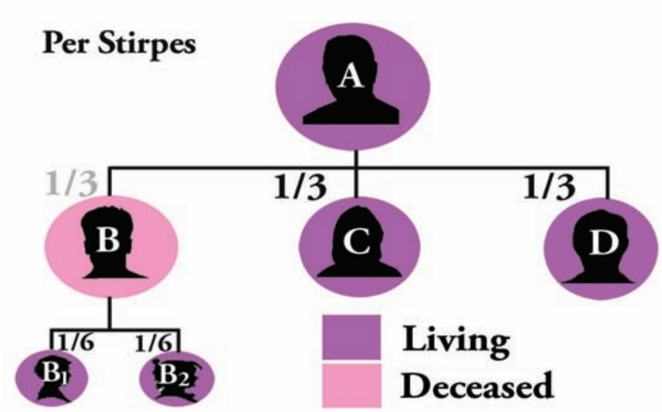
Before form books, we tended to find harmless errors. "I leave my child's share in trust and the trustee shall pay the share: 1/3 at age 30; 1/3 at age 35; 1/3 at age 40. The correct version is: 1/3 age 30, ½ the balance at age 35; the balance at age 40.

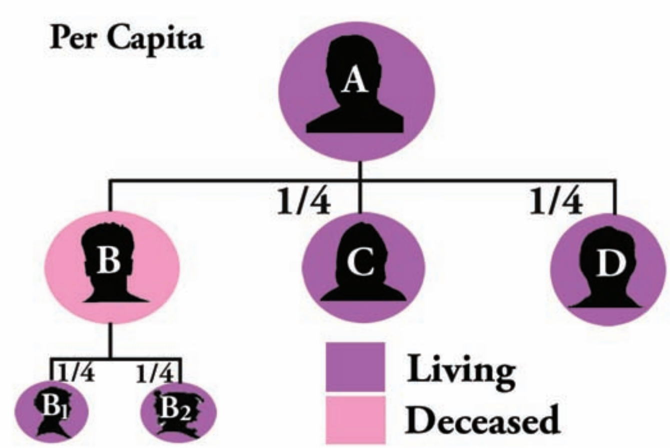
After the widespread availability of form books and word processors, some frequent errors disappeared and new ones appeared. A form book could get infected and the infection could last for years. Sometime in the late fifties, a draftsman came up with a way to minimize capital gains on funding the marital trust. The IRS subsequently cracked down on it and issued Revenue Procedure 64-19, denying the marital deduction if you used his specific language. We are still finding this violation today.

Recently I had lunch with a prominent and very knowledgeable estate planning attorney. Bragging about my forensic abilities to seek out this obscure virus, I stated that it really wasn't that important because the IRS would never catch the violation of 64-19. He then reminded me that he was the IRS attorney who audited me thirty years ago. *Oops.*

The two biases that stand out are *per stirpes* distributions and a preference for bloodlines. The former will have a great deal to do with whether your children think kindly of you at the first Thanksgiving following your demise and the latter whether your daughter in-law will think kindly of you. The disposition to children and grandchildren and spouses may have a dramatic impact on whether your legacy will promote lasting family harmony.

I have found over the years that children tend to think *per stirpes* but the parents tend to occasionally think *per capita*. What does this mean? Per stirpes (its Latin translation is "by branch" of the family) means that if you have three children and two grandchildren, each child will receive one third of your estate. If a child fails to survive, his or her issue will take the share the child would have received if living. *Per capita* (Latin for "per head") describes the creation of a share for each descendant regardless of his or her place on the family tree.





Frequently, we see parents creating educational trusts for grandchildren on a per capita basis and this does not seem to cause family tension. But if you leave your estate per capita, or if you have different percentages passing to your children, you may not fully appreciate the impact on sibling relationships. One of the more difficult challenges in estate planning is choosing among childrens' individual needs at the expense of family harmony.

From my experience, most children think that the decision of a sibling to have more children should not diminish their share, and this is amplified if a child has no children. Similar sentiments have been expressed regarding the tax-motivated $13,000 annual exclusion gifts, which may include grandchildren and spouses.

Most form books make it easy to go *per stirpes* and make you work to go *per capita*. And I think that is good. We should give very careful consideration to any provisions that do not treat children equally. The form book also defaults to a bloodline preference and I don't think that is a good idea.

Many trusts have generation-skipping objectives. Thus, a child's share is held in trust for life and then provides for distributions to that child's issue upon death or the age of majority. Frequently absent are provisions for the child's spouse. Most form books make it easy to follow bloodlines and hard not to. There is no break built in to remind the attorney to raise this issue.

It seems most trusts and wills today are very much like modern architecture. The possible loss of individuality and personality is a small price to pay for the comprehensiveness of the architecture of a "scalable trust". Brownstones tended to be 3 stories high, but modernism accommodates 3 stories or 60 stories. Scalability is important because if the tax law or the value of your estate changes quickly, your document adapts to the change. That said, I would like to leave you with a quote from the French statesman, Georges Clemenceau, after touring a very modern building. He commented: "It's all very nice, but what sort of ruins will it make?"

Thanks to John Freeman Gill, "Ghost of New York", June 2010, The Atlantic, and Robert S. Gallagher, "Wreker, Spare That Frieze!", American Heritage Magazine, August 1967, particularly for the Clemenceau quote.

Can We Help?

Part of our service to our clients is the availability, without charge, of our managers to discuss investments, either generally or specifically to an account. What is not well-known, is the willingness of our staff to share their expertise and experience in other areas that may be helpful to our clients. This is the first time that we have advertised this informal availability and we do so with some trepidation. Our concerns are availability of staff whose primary duties are the day-to-day administration of accounts and a clear definition that we are in a sense nurse practitioners whose primary role is to get you to see the doctor; in this case the specialist such as your accountant or attorney. Here is a list:

Garden Variety Trust Administration
All trust administrators

IRAs
Jeanne Gilbert and Mary Ann McDermott Reynolds

Roth IRA Conversions
Chris Chapman, Nanette Stevens, and George von Trapp

Estate Planning
Chris Chapman, Jack Davidson, and Jane Waysville

529 Plans
Chris Cassidy and Nanette Stevens

Fiduciary Income Tax
Bobi Flynn, Jane Waysville and Jack Davidson

The More Arcane Estate Planning Issues
Jack Davidson

Corporate and Partnership Income Tax
George von Trapp

Real Estate
George von Trapp and Sharry Rutken