Trust Company *of* Vermont Quarterly Update

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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

Employee-owned & Vermont-based www.tcvermont.com

Market Commentary

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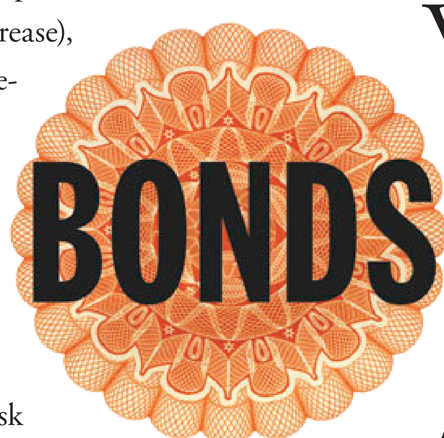
The bond market has been in a tizzy as of late due to recent comments by Fed Chairman Ben Bernanke suggesting quantitative easing (QE) could wind down this year or next. As a result, 10 year treasury rates increased from 1.6% at the beginning of May to 2.5% at the time of this writing. Since bond prices and interest rates have an inverse relationship (when interest rates increase bond prices decrease), bond investors saw their portfolios decline significantly in the month of May and into June. The Barclays Aggregate U.S. Bond Index fell more than 2% and bonds with longer maturity dates, and many international bonds, fell even more. These price declines have prompted investors to ask two major questions: 1) What is the Fed going to do? 2) How will this impact my bond portfolio going forward?



Since the financial crisis of 2008, the Fed has pursued expansionary monetary policy in an attempt to avoid an economic depression. Essentially, the Fed has been purchasing billions of dollars' worth of long term treasury bonds in order to keep interest rates at very low levels. Low interest rates, in theory, encourage borrowing by business and consumers and help many areas of the economy, including the housing market. If economic growth and inflation remain low and unemployment remains high, the Fed is likely to continue its quantitative easing policies, which will keep interest rates relatively low. However, if the economy continues to strengthen and signs of inflation emerge, the Fed is likely to take a more contractionary monetary approach, which will mean higher interest rates.

We caution fixed income investors not to panic after the recent two month rise in interest rates. In times like these, it is important to remember 1) why we own fixed income investments, 2) what type of fixed income securities Trust Company of Vermont purchases in client portfolios.

As investors, we own fixed income securities for a number of reasons, including preservation of capital, steady income and low correlation with equity markets. If I purchase a bond at par and interest rates suddenly rise, I will see the price of my bond decline. However, at maturity, I will receive the full value of what I paid plus a reliable income stream while I hold the bond. For long-term investors seeking preservation of capital and steady income, the price fluctuations in the bond market are not all that important. Furthermore, high quality fixed income portfolios tend to have minimal correlation with equity markets. While this is not a concern during rising stock markets, such as what we've seen recently, it does provide a lot of stability to an overall investment portfolio in times like 2008 when equity markets are falling.

At Trust Company of Vermont, our portfolios tend to have very high credit quality and a reasonably short duration. This essentially means that we buy mostly A, AA and AAA rated government, municipal, corporate and international bonds and that most of the bonds we buy have a maturity of 10 years or less. Fixed income portfolios with low durations and high credit qualities tend to hold up better in rising interest rate environments than fixed income portfolios with high durations and low credit qualities.

The stock market has been performing very well. The return on the S&P 500 stock index for the year ended May 31st was over 27% and the market hit an all-time high of 15,542 as measured by the Dow Jones Industrial average on May 22nd. The same day that the market achieved its high, Ben Bernanke spoke before Congress, giving the bull rally a pause and sending the Dow down over 200 points from its high.

Investors have been positioned for rates to stay low for a long time. There has been a big rush toward yield resulting in lower yields for high risk bonds and increased demand for higher yielding risk assets such as dividend-paying stocks and real estate. When they think that rates are going to go up, they begin to unwind these positions.

It is worth reminding and important for investors to remember that the Fed's reduction in purchases is conditional on an improving economy. They are looking for jobs to increase and for the economic recovery to become more self-sustaining. This is a good thing and we can equate it to the patient being released from the hospital, no longer needing the doctor's care.

We feel that while ours is not a robust recovery, it is a durable one and with tailwinds from the housing market and from continued relative stability in consumer spending, U.S. economic growth should be acceptable over the next couple of years and continue to be a safe haven amongst the developed markets.

Unfortunately, the same cannot be said for the emerging markets. We are seeing disappointing growth data out of China and other large emerging market economies. They have not been able to produce the kind of external demand that they typically get from Europe and the U.S. The strong US Dollar is also creating issues for many of the companies operating in these countries.

At Trust Company of Vermont, we believe that emerging market stocks possess outstanding long-term growth potential, and with current trading discounts of 28% to world equities, we feel that they can, where appropriate, still play an important role in client portfolios.

We expect that capital market volatility will remain high while the market tries to figure out what the Fed's next move will be. The market hates uncertainty, as we have witnessed over the last few weeks. It is during times like these when it becomes important to filter out the noise and take a long-term perspective.

Complexity

Jack Davidson

I suspect that were it not for the personal computer, our tax code would be far less complex today. When I started working at the Vermont National Bank Trust Department, our "sophisticated" calculator cost $1,500, which represented about 12.5% of my salary. Aided by up-to-date technology, I started doing fiduciary tax returns in early January. I worked nights and weekends, and relaxed on April 17th. Preparing a tax return using a pen and a calculator was fraught with tension. One error and I discarded the return.

Perhaps I suffer from a Tax Disorder. Perhaps it was my imagination, but the complexity of the tax code increased when our personal computers arrived. Otherwise, the populace would have rebelled. Was it just a coincidence in 1982, when I bought my PC, that the present Alternate Minimum Tax was enacted?

At some point I started to distrust the tax code or, more precisely, I may not have been up to understanding the complexities. So I embraced reverse engineering. I would input numbers into the software and the software would tell me the tax. Then I would reconcile the numbers with my understanding of the code.

My latest target is the Vermont Estate Tax. Reverse engineering of the Vermont Estate Tax revealed much. The tax return at first glance shows an increasing rate when assets pass the $2,750,000 exemption threshold, starting at 8% and capping at the highest rate of 16%. Reverse engineering revealed a different trajectory, starting at 35% and ending at approximately 10%

Complexity makes it harder for us to make good decisions. For example, legislators in Vermont recently proposed changes to the Vermont Estate tax law, claiming that the modifications did not create a Vermont Gift Tax. Fortunately, they decided not to make changes and voted to study the existing legislation instead[1]. Perhaps the legislators were influenced by some of us when we pointed out that the modifications expanded the gift tax already in existence for estates between $2,750,000 and $3,270,000[2]. Sometimes complexity has unintended consequences.

Complexity is also used as a tool to mask the less attractive aspects of a product or a service and sometimes as a tool to deceive. Most annuities and life insurance products fall within the safe category. On the other hand, funds comprised of investments that are not easily understood fall in the high risk category.

If the annuity salesman says that his product yields 4.68% and I calculate 2% using my simple spreadsheet, the annuity may not have been the best choice but the product is low risk if the provider is highly rated.

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[1] *H. 528*

[2] *The gift is brought back into the estate upon death.*

Sometimes the damage may be very harmful and the proposal may not appear to be complex. In the early seventies when the federal exemption was $60,000, I received a call from someone about to buy a 1 million dollar annuity paying 7% a year. The broker told him that the annuity would save all estate taxes, a sizable amount. The annuity payments ceased upon his death. I pointed out that if he died prematurely his wife and children may not have either a tax to pay or an inheritance.

I use the spreadsheet in a number of ways. I am also mindful of the banality of marketing: will I drift into using the spreadsheet and pie charts to deceive? I recently came close or perhaps I did deceive.

Last year I was attracted to a down jacket. A colleague suggested that I could wait a month and save 20%. I wanted the jacket! So I pulled up a spreadsheet, showed the life expectancy of the jacket, factored in the loss of one winter season if I waited, and made my case. My case was not persuasive so I shortened my life expectancy, recalculated, and made my case. Alas I had not factored in quality. This year the zipper broke in January and the jacket was not returned until the end of March.

Estate Planning is complex. For the most part, the goal is not marketing. If handled well, clients should be able to make the best choice. This is my role and this is my challenge.

When I am asked to evaluate an estate plan before the lawyer prepares the documents, I become suspicious when I see glossy presentations. Usually I am jealous. My spreadsheet lacks grandeur.

I recently evaluated a most impressive estate plan: page after page of colored charts. I thought I was looking at a Ferrari and my job was to look under the hood. I was not going to reverse engineer a Ferrari. I simply wanted to know what went into the formulas.

A key component was entered incorrectly. Things like this can happen. Consequently, the current tax projection over-estimated the tax. But then I noticed the marketing spin. The client was about to retire and live on his income. The program projected his future tax based on his life expectancy using either a Monte Carlo method or a Monte Carlo algorithm (or maybe they did the calculations in Monte Carlo?) I apologize. I really should understand this methodology. But it seemed strange that his assets would almost double in size in spite of the loss of his generous salary.

This program projected a sizable tax and created an urgency to embrace unnecessary complex tax saving strategies with unintended consequences.

I thought I was immune to gloss. That said I am having second thoughts. That winter coat that caught my eye, well it is glossy and it isn't very warm. Like many of our financial decisions, such as whether we take social security early or late, we are just trying to make educated guesses. Most decisions may not be perfect but we should be able to live with them. The winter coat, well, it has been re-branded. The jacket is a reminder of a less than perfect decision but one that still holds value. It functions very well in the first week of spring.

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