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Gold: The Ultimate Storehouse of Value or Just a Pretty Rock?

Todd E. Gray, Portfolio Manager

Gold Fever

The glitter of gold has been the cause of heartbreak, murder, wars and obsession throughout recorded history. For much of human history gold has been synonymous for wealth and the "Golden Rule" has been interpreted as he who has the most gold rules! The desire to own gold has been interwoven into cultures for thousands of years. Coins containing gold first appeared around 800 B.C., and the first pure gold coins were struck during the reign of King Croesus of Lydia approximately 300 years later. The tombs of many Kings and Pharaohs contained substantial amounts of gold that they believed would buy them favor with the Gods. Greek mythology touched upon the danger of man's love affair with gold through the story of King Midas. The obsession of humankind with gold is not just restricted to ancient history but also to more recent times as witnessed by the California Gold Rush, as well as the popularity of the reality show "Gold Rush" which follows modern day gold miners seeking fortune. Movies such as "The Treasure of the Sierra Madre", "The Far Country" and more recently "The Italian Job" all focus on the effect that gold has on the character and morals of ordinary people.

The Gold Conundrum

Gold has been a divisive issue for the investment community with gold "bugs" believing it to be the ultimate storehouse of value while stock aficionados view gold as just a pretty rock. Late-night television infomercials and radio advertisements pitch gold as the only hedge against a future where paper money and assets are worthless. Such claims tap into our fear that the end of life as we know it is fast approaching. It is tempting after listening to such dire forecasts to call the 800 number and start stocking up on gold coins or bars. Because of the constant promotion of gold as a panacea investment, we decided to address the issue in this newsletter. The goal of this article is not to make a case either for or against investing in gold, but to lay out the pros and cons of doing so.

Ultimate Storehouse of Value

Pros of Owning Gold

- Hedge against inflation
- Grows in value during times of financial crises
- Non-government currency

Gold has been pitched as a safe haven during times of high inflation, financial crises and geopolitical uncertainty. Over the past 50 years gold prices have generally risen and outperformed the stock market during periods of high-inflation. During the 1970s, when inflation increased at an annualized rate of 7.4%, gold prices increased at an annualized rate of 30.8% compared to the 1.6% annualized price return for the S&P

500 Index. However, during the period from 1975 - 2014, while the return on gold did outpace the rate of inflation by 0.8% annually, stock returns outpaced inflation by 8.3%.

Gold has often been called the "currency of fear" because people flee to its perceived safety when world tensions rise, or we experience a lack of faith in the financial markets. The best example of this was the recession and financial crisis of 2008. The price of gold jumped 131% from late 2007 to September of 2011, when it hit a high of $1,921 an ounce. This year we saw gold jump in price by over 10% in the week following the surprise Brexit vote.

There is an old saying that an ounce of gold will always buy you a good men's suit. This is essentially the argument of diehard gold bugs who want to own gold because it is a non-government backed currency. Currently no country backs it currency with gold. For half a century beginning in 1879, Americans could trade $20.67 in cash for an ounce of physical gold. The U.S. dropped the gold standard in 1933 and in 1971 severed the link between gold and the dollar, meaning the dollar is no longer "as good as gold". Throughout history, government issued currencies have all suffered from devaluation, often from poor financial practices, and the value of currency can be driven up and down by speculators through currency trading. The argument is that by owning physical gold, an individual has an asset that is a true storehouse of value that a paper currency can never be.

Just a Pretty Rock That Sits There & Looks at You

Warren Buffett, CEO of Berkshire Hathaway, is one of the most famous stock investors of all time. He is also one of the most outspoken opponents of gold investing. In a letter to shareholders in 2011 he wrote that the monetary equivalent of all of the gold in existence could buy all of the farmland in the U.S., plus 16 Exxons. He goes on to say "A century from now, the 400 million acres of farm land will have produced staggering amounts of corn, wheat, cotton and other crops, and will continue to produce that valuable bounty. Exxon will probably have delivered trillions of dollars of dividends to its owners, and remember you own 16 Exxons. Meanwhile, the 170,000 tons of gold in existence at that time would be unchanged in size and still incapable of producing anything."

Cons of Buying Gold

- Produces no income
- Volatile
- Speculative, no underlying intrinsic value

While gold has a reputation for being a storehouse of value, like stocks, the price of gold can drop as quickly as it goes up. In the wake of the 1970's oil crisis and high inflation, gold hit a record peak of $850 an ounce in 1980. It would be another 28 years until gold surpassed this level. After rising to $1,921 per ounce in 2011, gold prices dropped to $1,184 by the end of 2014.

Since gold produces no income, it is intrinsically worthless or priceless. Unlike stocks, which represent ownership of an actual business that generates a cash flow creating an intrinsic value, there is no way of calculating the actual value of gold. It is simply a matter of what buyers are willing to pay for it. Warren Buffett explains this well, saying "Gold is a way of trying to profit from fear and it has been a pretty good way of doing so from time to time. However, to profit, you have to hope people become more afraid in a year or two than they are now, or you will lose money because gold itself doesn't produce anything."

In summary, although gold is not a panacea for inflation, it has produced a return that exceeded the rate of inflation. History has also shown that gold has done well in response to unexpected

crises, however, its returns relative to stocks during prolonged periods of troubles have been inconsistent. In an article by Jason Zweig titled "Let's Get Real About Gold: It's a Pet Rock", he writes "Own gold if you feel you must, but admit honestly to yourself that you are relying on hope". Here at Trust Company of Vermont we have not had a dedicated allocation to gold, instead investing in it on an individual basis to meet specific client concerns. We encourage clients that want to invest in gold to limit it to a small part of their total investments. To invest a substantial portion of your investable assets in gold is, as Zweig writes, "a leap in the dark that not even gold's glitter can change".

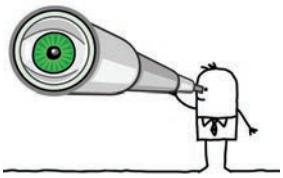
BEWARE

Legislation May Have Amended Your Trust Without Your Knowledge

One of the most important items in a trust agreement's list of trustee responsibilities is the instruction regarding notice to beneficiaries. It is often overlooked, however. That particular language says who will see your trust, its assets, and transactions once your trust becomes irrevocable – and that is most often on the owner's death. A trust written inside a will, called a testamentary trust, is public. Most lawyers recommend living trusts to avoid the cost and oversight of the probate court *and* to ensure confidentiality, among other reasons. Unlike a testamentary trust, a living trust is private. However, standard notice language under a relatively new law can sometimes let more people see the trust, its assets, and transactions than you want.

Before the Vermont Legislature enacted the Vermont Trust Code, which modernized trust law and made improvements of many kinds, a trust would define how private the trust would remain, and absent such provisions, the trustee would make the determination. However, the new VTC included an important notice modification in its passage titled, "Duty to Inform and Report." As a result, a trust may not be as private as you thought, once you are gone.

If you created a living trust before the new law's effective date (July 1, 2009), and it was revocable on the date of enactment, the new notice rule will eventually apply. Importantly, however, you may still be able to override that rule, which applies only if you don't specify otherwise.



Do you want your child's divorced spouse to see the document, the assets and the transactions, of your trust set up for your children and their descendants? Do you want a charity to see what your family trustee is doing for your family members if the charity has an interest that may not materialize for many years?

The new law created several tiers to inform and report. The first tier makes sense: *"(i) a "first tier" beneficiary is a distributee or permissible distributee of trust income or principal;"*

It is not mandatory to give notice to second-tier beneficiaries. You may not want those beneficiaries, who take at the end of the trust's life, to have that information until they are entitled to their eventual benefits. Unless you direct otherwise, both they and any charitable remainder party will have the right to request information – and the trustee will have the duty to let them know their rights. Fortunately, you can amend your trust's provisions to limit the Duty to Report and Inform to just the first-tier beneficiaries.

But should you? It may be a good idea to let second-tier beneficiaries in on the information – and to provide oversight -- if, for example, a family member is both a first-tier beneficiary and a trustee with powers to make distributions.

If your trustee is a corporate trustee, which provides both private oversight (as opposed to court oversight) and notices, a requirement to notify just the first-tier beneficiaries should be more than adequate.

Alternatively, or in addition, you might consider enabling a Trust Protector who is not a beneficiary to have some powers, including oversight.

Privacy is important. Oversight is important. Avoiding divisiveness in the family is also important. We recommend discussion of this sensitive issue with your estate-planning attorney.

- Christopher G. Chapman, Trust Administration

Spousal Trusts

Angela Bowman, Trust Administrator

Can I have just 10 minutes of your time? It's hard to believe that it has only been two short years since I joined the Trust Company of Vermont. My first day, I thought that I would be doing the same thing I had been doing for the previous ten years; trust administration. I soon learned that at TCV, we didn't just wear one hat and quickly adapted to the many that I wear now. Some of them are pretty simple... who can be the first to install air conditioners in the summer? Others, more complex - what type of tax savings trust should I use? It is these more complex issues that I would like to address periodically. I have learned that a 10-minute training can be more effective than an hour-long one. At times, of course, 10 minutes turns into 20 plus, but I will try to stay on topic and not digress.

With estate planning you have options and options within those options.

Many of our clients have trusts, or are in the process of updating their estate plans to include trusts. Reasons to have a trust include saving estate taxes, avoiding probate, confidentiality, taking care of children, sheltering assets from creditors, and the list goes on. If you are married, you have additional options as to what type and provisions to add to your trust to ensure your spouse's and family's needs are adequately met.

Often the more complicated trusts are designed to take advantage of the federal and state estate tax rules that allow for your property to pass to a surviving spouse and children without being taxed upon the first death while eliminating or reducing the taxes upon the death of the surviving spouse. Currently, both the federal law and Vermont law allow for an unlimited marital deduction. The focus of most tax-savings trusts is to avoid the tax when the second spouse dies. When there is no marital deduction you will need to add additional language to be sure you eliminate or reduce an estate tax. Below are a few types of trusts and provisions to consider when creating an estate tax savings trust.

If the total of all marital assets range from $2,750,000 to $5,500,000, we recommend either a Disclaimer Trust or a Fractional QTIP Trust. If the estate is above $5,500,000, we also add the Credit Shelter Trust to our preferred list.

Disclaimer Trust

A disclaimer trust allows you to leave everything to your spouse, except that they have the option to disclaim a portion, or all, of the proceeds. This is a very simple tool to use if you do not foresee your estate going above the exemption amount, but allows for flexibility in case it does. The amount that your spouse disclaims can then go into a trust for his or her benefit. Spouses can even be the trustee of this trust, which provides not only the income, but the principal, as long as the standard for invading principal is an IRS sanctioned standard such as distributions for "health, education, support and maintenance". Often you can avoid capital gains tax by using this type of trust when selecting assets to go into the trust.

One of the drawbacks of the Disclaimer Trust is that the survivor must disclaim within 9 months of the spouse's death and cannot take any funds from the trust before making the election.

Fractional QTIP Trust

QTIP stands for "qualified terminable interest property". These are most commonly used by people

who want their spouse to have access to the income for their life, but transfer the principal later on to the children. For example, if you are in a second marriage and have children from a previous one. Or, if you are worried about the impact on the children if your spouse marries again. It gives the surviving spouse 100% of the income for their life, and rights to invade principal using standards similar to a Disclaimer Trust. Upon the surviving spouse's death, the principal is distributed to, or in trust, for your children.

Unlike the Disclaimer Trust, the trustee has 15 months to fractionalize the trust for tax benefits, but the assets are secure. By choosing a fractional QTIP, you can choose that portion that will save estate taxes (the QTIP portion) and that portion (the non-QTIP portion) that can save capital gains tax . You can even include children as beneficiaries while the spouse is alive for the non-QTIP.

The Credit Shelter Trust

The Credit Shelter Trust is the "B" Trust of an AB Trust plan. The "A" Trust is the marital bequest, or trust for a spouse. The "B" Trust, also known as a "Bypass" or "Family" Trust is designed so that the trustee shall put aside the smallest amount which would result in no tax. Currently in Vermont, you would fund the Credit Shelter with $2.75 million to avoid any state estate taxes, with the balance passing to the "A" Trust. This amount will now be available for the benefit of your spouse and/or children, but would not be taxed. We only recommend this trust for the very large estates, when the range of spousal estates is above $5,500,000. The primary drawback of over-funding the trust is the loss of savings in capital gains tax.

In short, what does all this mean to you? You have options when creating your estate plan. We recommend that you continually review your plan to ensure that it meets your needs and incorporates changes in both state and federal laws. Also, when you meet with your trust officer or attorney to do so, don't just think about your current situation and the assets you currently have. Are you expecting an inheritance down the road? Is your spouse? Is this your second marriage? Do you think your spouse will remarry after your death? These are all important questions that you should discuss openly and honestly because, with a little planning, you will be able to save on estate taxes and take care of both your spouse and children.

The "QTIP"

Jack Davidson

This acronym has an emotional history for me. As a youth, when my mother would come into my room with a QTIP, I felt fear. Then in January of 1982, I felt fear followed by a surge of appreciation that has lasted to this day.

It was late January. I was handed a trust of a well-known business man in his community, who died on January 8, 1982. I panicked. The marital trust did not qualify for the marital deduction.

In 1982, the federal exemption was $225,000 and the maximum tax rate was 65%. In those days, estate planning lawyers used AB trusts. The A Trust was a marital trust that would not be taxed, and the B Trust, also known as the "Bypass" Trust or the "Credit Shelter" Trust, was to shelter the exemption. No tax on the first death (the husband in this case) and no tax on the B Trust when the wife died.

In those days the federal law allowed the marital deduction for outright distribution to the spouse, as well as a marital trust for the spouse so long as trust income was paid annually to the spouse, and no one other than the spouse had rights to the principal. In addition, the spouse had to have the right to appoint the property to anyone upon death. The spousal interest did not terminate..... it was just delayed.

The B Trust was designed so it would not be taxed in the surviving spouse's estate. Often the only reason to control the assets was simply to save estate taxes when the spouse died. The surviving spouse's interest would terminate on death and the assets could be used for others, such as the children, while the spouse was living.

This anxiety-provoking marital trust A had been signed in the late 70s. Upon the death of the business owner's wife, the wife had the sole right to the income, and the property went to their children upon her death, but she had no control. It was probably a scrivener's error and I felt the pain.....the impact on the wife, and the children, and the scrivener.

I was looking at an "accidental" QTIP. At first painful, it saved the patient.

Fortunately, Congress had just passed a change in the law, effective January 1, 1982, that allowed a certain type of marital trust to terminate the wife's interest, upon her death, and still be entitled to the marital deduction. The change allowed me to take the deduction. The new law stated that income must be paid to the wife annually, no one else could have an interest in the trust while she was alive, and I had to qualify the trust on the tax return. That is why they call this a "Qualified Terminable Interest Trust". It met the definition of "terminable" and I qualified the trust when I filed the estate tax return.

This may have been one of the first QTIP trusts in the country, and I can wax endlessly about the wisdom of our legislators who envisioned the benefits outlined in Angela Bowman's article.

Angela's article discussed the fractional QTIP, which is just another way to create AB trusts with more flexibility. I did not tell her about this story in her presence because I wanted to avoid her response: "I was not born then".

P.S. She just corrected me.....she was 9 months and 30 days old.

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