Trust Company *of* Vermont
Quarterly Update
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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester

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The Nifty Fifty & the trauma of the Beep

Jack Davidson

I was hired as a trust administrator at the Vermont National Bank in November of 1970. The market was doing well and life was pleasant. Fortunately, I was not prone to managing portfolios, but my supervisor was a skilled manager who knew how to manage risks.

He was also a fan of the Nifty Fifty. "Nifty Fifty" was the term we used in the '60s and '70s as a description of a stock portfolio consisting of fifty popular large-cap stocks on the New York Stock Exchange. They were regarded as solid "buy and hold" "blue-chip" growth stocks and were credited with the bull market of the early 1970s.

As the end of 1972 approached, my supervisor changed. My new boss appeared to be a devotee of the Nifty Fifty as well, and I simply expected another year of growing portfolios and those smiling neighbors who were our clients. In my new and growing comfort zone, somehow I was able to find a device installed by a local broker that would alert us to a change in the value of securities that we held with the broker. The device would simply beep whenever a specific security would increase or decrease in value by 5%.

Then the device starting beeping. It was the start of the year 1973. Whenever I would hear the beep, I would check the device and one of our stocks just went down. For the next two years I would only hear negative beeps. The trauma of the market started on January 11, 1973 and ended on December 6, 1974. During this two year period, the New York Stock Exchange's Dow Jones Industrial Average benchmark (the "Dow") lost over 45% of its value. The Nifty Fifty did worse. The Dow's recovery was a very long recovery and did not reach its previous high until 1982. As I recall, I returned the beeper to the broker sometime in the mid '70s. Should I have returned the beeper? Yes. Beepers don't match long-term investing. On December 31, 1982, the Dow was 1046.54. On December 31, 2019, the Dow was 28,538. I would have encountered many years of positive beeping. It is simply a distraction. Long-term management is best suited in a beepless and quiet room, devoid of distractions.

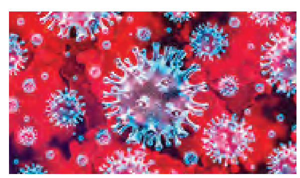
FINANCIAL HEADLINES

Ben Ferris, CFA & Portfolio Manager

Financial headlines are dominated by well-known conditions and widely anticipated events such as actions by the Federal Reserve and trade disputes by world powers. Incremental developments, and market participants' subsequent emotional responses, tend to drive markets in the short term. It's always hard to know exactly why participants behave the way they do in the short term. I'm sure it is some cocktail of expectations, emotions, fundamentals, and pure randomness. On any given day, the sheer number of players, economic factors, and business developments defy any single person's ability to fully comprehend what is going on and why. Yet, there is no shortage of seemingly intelligent financial strategists and market pundits claiming to know just why markets have behaved the way they have and just where they're going.

I'll pick on JP Morgan US equity strategist Dubravko Lakos-Bujas, who told CNBC on December 12th of 2019 that he believes the S&P would end 2020 at 3,400. He firmly believed that the "business cycle shows more acceleration" and that "the rotation that began at the beginning of September (2019) continues to move forward towards the cyclical trade." Just three and a half months later, the S&P 500 is down 29%, to about 2,240 at the time of this writing. Industrial companies tend to be one of the most cyclical industries within the S&P 500. XLI, an Industrial Sector ETF, is down roughly 13% since Lakos-Bujas made his bullish call on the "cyclical trade." This is a short-term prediction, and short-term thinking is bound to produce critical errors. Strategists aren't bad people for making predictions, it's what they're (handsomely) paid to do. They just aren't paid to do it accurately, and it is important to remember that because no one can do it consistently.

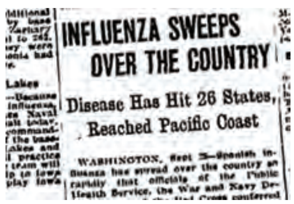
Interestingly, there was no mention by Lakos-Bujas about the potential for a worldwide pandemic as a risk to his short-term price target on the S&P 500. And that is the problem with making market predictions and trying to time the market; there are just too many variables that can impact the global economy. The emotions of the market can be just as unpredictable and usually are determined by fear/greed and short-term thinking. Fear has driven the price of many high quality companies down significantly.



Emotions drive stocks in the near-term, but business fundamentals prevail in the long run.

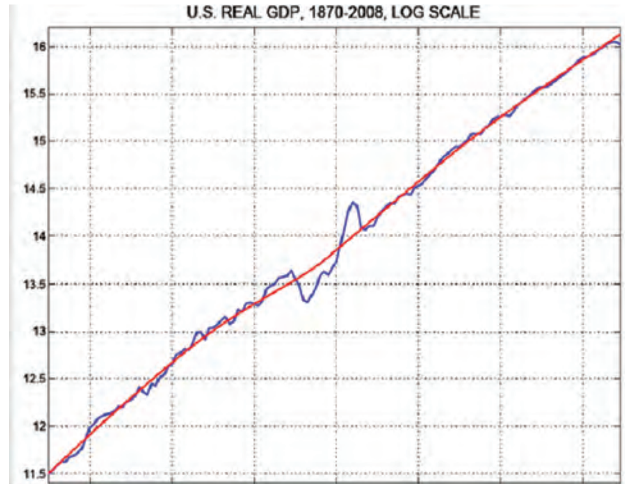
If you owned 100% of a small business or rental property, would you rush to sell at a fire sale price if you heard coronavirus was making its way into the US? How about an interest rate change from the Fed, or a trade war with China? I'd venture to guess that you'd put some pretty good thought into how the business/property would be impacted over the next 10 to 20 years. So why do so many investors rush to the exits in the stock market when such news transpires?

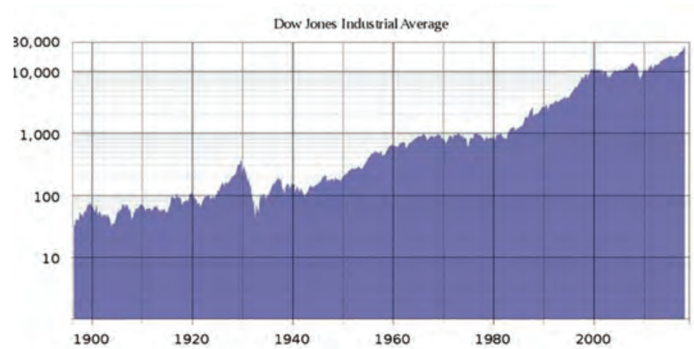
I've seen examples comparing coronavirus to the Spanish Flu of 1918 as both viruses are similar in contagiousness and initial fatality rates. The Spanish Flu was absolutely devastating. According the Center for Disease Control, it "was the most severe pandemic in recent history… It is estimated that 500 million people or one-third of the world's population became infected with this virus. The number of deaths was estimated to be at least 50 million worldwide with about 675,000 occurring in the United States." At the time, 675,000 people was about 0.65% of the US population. With a current population of 327 million, 0.65% of the United States is 2.1 million people. The loss of human life is not something to be taken lightly. However, as investors it is imperative to keep a level head, to maintain perspective, and to look at how history has unfolded following pandemics. All advances in modern medicine, global coordination and hygiene aside, let's assume coronavirus gets as bad as the 1918 Spanish Flu. So how did the US economy and stock market perform during and following the 1918 Spanish Flu?


INFLUENZA SWEEPS OVER THE COUNTRY

Disease Has Hit 26 States, Reached Pacific Coast

Here are two graphs in log scale, one showing real GDP and the other, the Dow Jones Industrial Average:





When taking a long-term perspective, there is no noticeable impact in either real GDP or the Dow Jones Industrial Average from 1915-1920. The American Tailwind, as Buffett calls it, has proven to be resilient for centuries. I won't attempt to summarize his writing, but here is the link to the 2018 Berkshire Annual Report in which he talks about it. https://www.berkshirehathaway.com/2018ar/2018ar.pdf.

The nature of the stock market is transactional. We can buy or sell any number of securities instantaneously and at essentially zero cost. While it is incredibly easy to bounce from one stock to the next, one should not view stocks as a digital piece of paper that wriggles around in price every day, but as a very real ownership interest in a business. In times of panic, people see red on their screens and the natural emotional response is fear, worry, and anxiety. The corresponding physical response is sell, sell, sell. There is no doubt the coronavirus will have a widespread negative economic impact on the global economy – in the short term, but we must ask ourselves whether the economic outlook for the next 10 to 20 years has dramatically changed over the last couple weeks. It is times of uncertainty when opportunity presents itself. As Warren Buffett's adage goes, "be greedy when others are fearful."

To avoid all the whiplash and associated headaches, Trust Company of Vermont has developed a set of principles that tells us what to do over the long-term in the face of day-to-day changes in asset prices and business fundamentals. This is at the core of value investing. Our challenge is to weed out the noise, control our emotions, use our analytical abilities, and purchase assets in the market when the price at which they are selling is markedly below what we believe them to be worth. By sticking to our value investing guns, we can avoid the pitfalls of short-mindedness, avoid latent risks, and earn our clients satisfactory returns on their capital.

How Is the Dow Jones Industrial Average Calculated?

Bonnie McLellan, Portfolio Manager

In 1987, a year after I started working in a trust department as an assistant portfolio manager, the DJIA (Dow Jones Industrial Average) was trading around 2,000. That year on October 19th, Black Monday, the market lost 508 points in one day, down a historic 22.6%. You could not sell or buy stocks because the market was overwhelmed, and trading was accelerated by the use of computerized trading. I remember listening to the radio, not believing what was happening. Real-time information was not as accessible as it is today and typically required a phone call to a broker to obtain. Since then, the New York Stock Exchange has installed 'circuit breakers', designed to stop trading when stocks decline too quickly. Today, if stocks lose 7%, the trading on the market is suspended for 15 minutes. A market decline of 20% would shut down trading for the remainder of the day.

The Philadelphia Inquirer

Dow Dives 508.32 Points In Panic on Wall Street

Navy blasts Iran oil site in retaliation

Billions lost in trading

This is not the premise of this story, but an example of what has happened to the DJIA in the past. Since then there have been many volatile days and weeks. Monday, March 2, 2020 was the largest one-day increase of 1,293.96 points, or 5.09%, for the index. That preceded Monday, March 9th when the index saw its worst one-day decline of 2,013.76, or 7.79%. But here we are still trading at a level more than 1,300% higher than we were at the end of that dark day in October, 1987.

How are those moves calculated?

The Dow Jones Industrial Average is computed by taking the average price of the 30 stocks that make up the index (constituents) and dividing that figure by a number called the Dow Divisor.

"The Dow Divisor is used to maintain the historical continuity of the index. It does this by factoring in the many changes that take place among the index constituents such as stock splits, spinoffs and changes to – or payments of – dividends going back to when the index was first introduced in 1896.

The Dow Divisor is adjusted to ensure that such events do not, in and of themselves, alter the true numerical value of the DJIA. Because of major changes that have taken place within the market historically, the value of the Dow Divisor has changed significantly over the years. For example, it was at 16.67 back in 1928, but was at 0.147 as of September 2019." [1]

In 1896 the Dow Divisor was named after Charles Dow, an editor for the Wall Street Journal who partnered

with statistician Edward Jones to form the first version of the DJIA. Since that time, the Wall Street Journal has been responsible for making sure that the Dow Divisor is adjusted properly to maintain the DJIA's historical accuracy.

$$\text{DJIA} = \frac{\sum p}{d}$$

[1] Source: Investopedia

Example of the Dow Divisor

If the sum of the prices of the 30 stocks that make up DJIA is 4,001, dividing this figure by the Dow Divisor of 0.147 would provide a level of 27,220 for the index. The Dow Divisor was 0.147 in Sept. 2019. Using this divisor, every $1 change in price in a particular stock within the average equates to a 6.8 (or 1 ÷ 0.147) point movement.

The Thirty Stocks That Make Up the DJIA

3M	Diversified Industrials
American Express	Financial Services
Apple	Information Technology
Boeing	Aerospace/Defense
Caterpillar	Farm/Construction Equip.
Chevron	Oil & Gas
Cisco Systems	Computer Systems
Coca-Cola	Beverages
Dow	Commodity Chemicals
ExxonMobil	Oil & Gas
Goldman Sachs	Financial Services
Home Depot	Home Improvement
IBM	Information Technology
Intel	Semiconductors
Johnson & Johnson	Pharmaceuticals
JP Morgan Chase	Financial Services
McDonald's	Food Industry
Merck	Pharmaceuticals
Microsoft	Information Technology
Nike	Apparel
Pfizer	Pharmaceuticals
Proctor & Gamble	Household Goods
Travelers Insurance	Financial Services
United Technologies	Diversified Industrials
United Healthcare	Healthcare
Verizon	Telecommunications
Visa	Information Technology
Walgreens	Retailing
Wal-Mart	Discount Retail
Walt Disney	Media/Entertainment

Working at Home and the Pandemic's Affirmation of its Values

Jack Davidson

After I arrived in Vermont from New York City, my daily 2 hour subway commute changed to 20 minutes a day, in my warm and cozy car. Subways in those days did not have functional air conditioning, and sometimes when I ended my morning commute to Wall Street, I had to deal with a soaking, white shirt after spending an hour standing close to other straphangers. Not so in Vermont, and I did not need air conditioning in my car. I would just open a window and in a flash I'd be sitting in my new office in Brattleboro. That is, until one day when snow and ice intervened and my car did a 360 degree spin. Rather than spending my day in a warm and cozy office, I was sitting in a very cold garage as a mechanic added studs to my tires.

I also had to learn the business rules that may have been unique to Vermont, but perhaps not elsewhere. My first mistake was a very significant cultural mistake. Every month we would have a Directors' Trust Committee meeting in Woodstock, Vermont. The average commute for the Directors was a one-hour drive. Having been informed of a projected snow storm, I canceled the meeting. I was told by the higher-ups that no meetings, regardless of weather, should ever be canceled. I sometimes refer to this as a ***cultural misunderstanding***.

As the years passed, I encountered the personal computer. Its cost at the time was $12,000, when nice homes cost $50,000. I fell in love with PCs and, when the cost descended to an acceptable range, I started buying personal computers for staff members, and personally installed a few in staff homes, once they had access to the internet. The PC was a life-changer. Staff could work at home. I wanted to work at home when I needed to focus free of the interruptions found in most offices. But then once again, I discovered that most of my colleagues did not want to work at home. Another ***cultural misunderstanding.***

In my early years, our headquarters were in Brattleboro. Then we opened up branches in Rutland and Burlington, and long drives became the norm. After we formed the Trust Company of Vermont, technology was growing lightning-fast. Why not have big screens, and have the client in Brattleboro meet with a manager based in Burlington on the screen, instead of a 5 hour drive? Do our managers do this? Sometimes. Often, they cluster several client meetings and hop in the car. Another ***cultural misunderstanding***.

At the Trust Company of Vermont, we built a system that encourages working at home, in anticipation of a cultural change. This included hiring an outside firm to make sure any offsite communications are not vulnerable. Staff are not allowed to take documents offsite and everything is stored in an internal and highly secure system.

Well, it has arrived faster than we thought now that we have a pandemic. Our system was ready. It allows us to do asset management and trust administration offsite, wherever we may be located. That said, we also like the old-fashioned way of meeting in person with our clients, and this is our plan once the pandemic goes away.

Congratulations

to Mary Ann McDermott, long-time administrator in our Burlington Office, who retired at the end of 2019. Mary Ann joined us in the very early days of the company, and her many clients benefited from her skill and experience. Her camaraderie, counsel and exceptional patience will be missed by all of us. Enjoy retirement, Mary Ann!

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The IRS Says Your Child is Now Age 92

(The SECURE ACT & Your IRA)

Jack Davidson

Who Wins and Who Loses

As of January 1st of this year, federal legislation governing the tax treatment of qualified retirement plans and IRAs has created opportunities for some, but not for others:

Who Wins?

You, if you are the owner of the IRA. In the past, if you wanted to work after age 70½, you could not continue to make contributions to IRAs. Now you can. Work to 100, and you will have many years to add to your retirement savings on a tax-advantaged basis.

Who Wins?

You, if you are owner of the IRA and your spouse is the beneficiary. Those who have reached age 70½ after December 31, 2019 may defer withdrawals until age 72 years. Spouses will benefit as well.

Who Loses?

Your children. Before the SECURE ACT, IRA withdrawals for children, which, based on their age, meant in many cases very slow withdrawals. Not anymore, and the tax bite can be severe, especially if property is held in trust for their benefit. Now, in most cases, we have to empty out the IRA by the tenth year after death, unless the child is under the age of majority, or in college, which will delay the start of the 10-year rule. Our next newsletter will address this complex issue. For some, if not many estate planners providing for children, it's an INSECURE ACT.