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Consider the Fed

Charles Boardman, TCV Intern & UVM Business Major

First consider Hé-no, Thunder God of the Iroquois. His mission was to protect the villagers and to bring rain, which nourished their crops. Wielding a magical feather and chert arrows, he smote evil spirits and witches. Hé-no once slayed a giant serpent that had been terrorizing an Iroquois village.

Now consider the Federal Reserve System, the central bank of the United States. Per its website, the Fed is mandated to "promote maximum employment, stable prices, and moderate long-term interest rates in the U.S. economy." Much like Hé-no, the Fed's general mission is to safeguard the welfare of the people and bring them prosperity, just with appropriate monetary policy, not rain and chert arrows.

Consistent with the Iroquois' tenuous grasp of Hé-no and his powers, Americans, in large part, know surprisingly little about one of the most powerful and influential institutions in the world, the Federal Reserve. Furthermore, while the Fed appears frequently in all investment publications and news sources, it remains a mystery to many of the people it affects. This article will provide a glimpse of this mysterious institution and its influence on financial markets.

As the central bank of the United States, the Fed protects the nation's economy and financial system through five main functions: controlling U.S. monetary policy, maintaining the stability of the financial system, fostering the safety and integrity of individual financial institutions, managing payment and settlement systems, and protecting the welfare of consumers and communities. Created by the Federal Reserve Act of 1913, the Fed comprises three main entities: the Board of Governors, the Federal Open Market Committee (FOMC), and the Federal Reserve Banks.

The Board of Governors, a federal government body supervised by Congress, oversees the Fed, the 12 Reserve Banks, the discount rate, and the reserve requirements. The discount rate serves as the interest rate regional Reserve Banks, the operating arms of the Fed, will charge commercial banks or other depository institutions on loans. The reserve requirements mandate the minimum amount of vault cash or deposits in Federal Reserve Banks that banks must maintain to service withdrawals and withstand crises. The Board includes seven members, who are appointed by the President and confirmed by the Senate. All seven members sit on the FOMC.

The Federal Open Market Committee, comprised of the seven Board members as well as Reserve Bank presidents, handles the Fed's open market operations. These operations consist of buying and selling government securities to influence the amount of money in the banking system. The Chair of the Board of Governors also serves as the FOMC Chair. The Fed's current Chair is Janet Yellen, the first woman to ever hold the position. This committee meets regularly to discuss the state of the economy and determine future monetary policy.

Through changes in monetary policy the Fed can alter both short-term and long-term interest rates, foreign exchange rates, and the supply of money and credit. These alterations, in turn, influence certain macroeconomic variables such as unemployment, prices, and output. Increasing interest rates makes borrowing money more expensive, therefore companies will take on less debt. When borrowing decreases, companies generally have less capital on hand to grow, which has effects on hiring, prices, and output. Expanding or contracting the money supply through open market operations causes inflation to fluctuate, affecting prices and foreign exchange rates.

Since 2008, monetary policy has been very expansionary, with the Fed keeping rates near zero since the crisis. However, at its March meeting the Fed decided to hike rates for the third time since 2006 and the second time since December. The Fed Chairwoman, Janet Yellen, in the press conference following the meeting, maintained that the economy is doing well and that Fed officials have confidence in its robustness and resilience to shocks. As such, the Fed expects two more rate hikes this year and three the following year.

One must assume that winter storm Stella slamming the eastern U.S. a day before the Fed's March meeting could only be one thing:

A MESSAGE FROM HÉ-NO TO RAISE RATES!

We continue our history of enthusiastic March Madness competition!

Past Winners

2009	Steve Singiser, Portfolio Manager
2010	Angie Freeman, Operations Manager
2011	Kathy Patenaude, Trust Clerk Chris Chapman, Trust Administrator
2012	Chris Cassidy, Portfolio Manager (and AAU Basketball Coach!)
2013	Butch Hebert, Portfolio Manager
2014	Lori Miller, Operations Ellen Lowery, Auditor
2015	Lori Miller, Operations
2016	Steve Singiser, Portfolio Manager

2017?

On the eve of the Final Four, the top contenders of those still in the running:

1 - Lori Miller, Operations, with Gonzaga

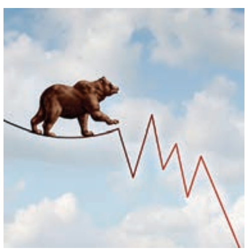
2 - John Abel, Portfolio Manager, with UNC

3 - Jack Davidson, Administration, with Oregon

A Bear Market Anniversary

Todd Gray, Portfolio Manager

Eight years ago, on March 9, 2009, the S&P 500 stock index bottomed at 677, representing the end of a 17 month bear market in which the value of this index fell 57%. Do you remember how you felt about the U.S. economy and the stock market on that day? Chances are your

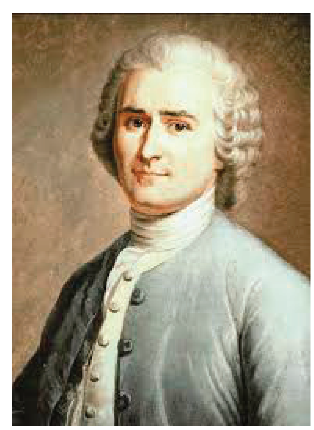


feelings reflected those of investors surveyed by the American Association of Individual Investors. Their weekly survey conducted on March 4, 2009 indicated that 70% of those responding were bearish, the highest bearish measurement ever recorded by this study. On this day eight years ago John Authers, a journalist for the Financial Times newspaper, wrote concerning the U.S. stock market that "perhaps the greatest reason for hope at present is that almost all hope seems to have been lost."

As I have pointed out in previous communications, there is danger in being either significantly underweight or out of the stock market entirely even during the worst of times. In the first two years following this market bottom, the S&P 500 Index gained 102% (including the reinvestment of dividends). Over the next six years the same index gained an additional 107%. Since March 9, 2009 the market value of the U.S. stock market has increased by $21 trillion, according to Wilshire Associates, despite events such as the "Flash Crash" in 2010, the downgrade of the U.S. credit rating in 2011, numerous "fiscal cliffs" involving our national debt and, more recently, the surprising results of both the "Brexit" vote and our own presidential election.

What comes next is impossible to say. Pessimists are concerned about high valuations and uncertainty emanating from Washington DC. Optimists point to the potential shot in the arm to corporate profits resulting from potential tax cuts, less regulation and a sizeable public infrastructure program.

I believe that the lesson that should be learned from the past eight years is that successful investing is more a result of time than timing. As has been often quoted, patience is indeed a virtue. When it comes to taking a long-term view on the stock market, I think the following words from writer and philosopher Jean-Jacques Rousseau describes it perfectly:



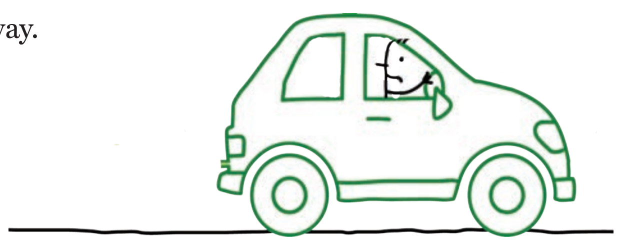
"PATIENCE IS BITTER BUT ITS FRUIT IS SWEET."

Grandfathering, my Subaru, and Special Needs Trusts

Jack Davidson

At age 28, I was carded while buying a bottle of wine. I had brown hair and I was questioned whether I was over age 18. Like my father, my hair started turning white very quickly. At age 32, I looked 42. In four years I had aged 24 years. When I was 35, I was interviewed in the process of renting a one-week vacation home and was asked, "Are you retired?" I was with my young family and suddenly I had become the "grandfather". My wife has always looked younger than her age and on more than one occasion she was asked, "Why did you marry a much older man?" Her response: "He is only 3 years older".

I am sensitive to this issue. Fortunately, the only time that I feel like a grandfather is when I back out of my driveway.



My Subaru

My motive in buying a Subaru, at first glance, looked like my efforts to drive safely in Vermont winters. It wasn't. I simply fell in love with the new gadgets. It was a happenstance visit to a local dealership and I fell in love with the back-up camera and the apps that appeared on what looked like an iPad on the dashboard. Now I could address the problem of backing out of the driveway. Often I would say, I am 90 years old when I back up, but when I drive forward I am still 18. Then I discovered so many other safety features to justify the purchase....that is until I discovered that the enhanced features may have even created greater risks. I found five manuals with over 1000 pages in the glove compartment to help me understand the car I had just bought. I am simply not able to understand most of the features, but I try, unfortunately while driving and looking at the screen to my right on my dashboard.

My Subaru has some nice safety features. If I start to stray out of my lane, a buzzer will sound, hopefully in time. But am I safer now then when I owned an old Dodge Dart when I was 28? Probably not. In those days I simply turned on the radio and my right hand scrolled through stations until I heard the station I wanted. My eyes rarely strayed from looking over the steering wheel. If I were an advisor to the auto industry, I would simply suggest strapping an iPad over the steering wheel, rather than looking at a screen to my right, for a better field of vision.[1]

Grandfathering

In the world of estate planning, we often make decisions based on the concept of grandfathering. The term "grandfathering" is used to describe a statutory or contractual willingness to allow some activities or former rights to continue, even though not technically allowed under current law. In the tax world it dominates. For example, we encourage clients to use their assets to make gifts to save taxes, and, if the tax law changes, the gifts ordinarily would escape taxes in spite of the change in the tax law.

Why the name "grandfathering"? I don't know, except perhaps to evoke an image of being kind to our grandfathers who

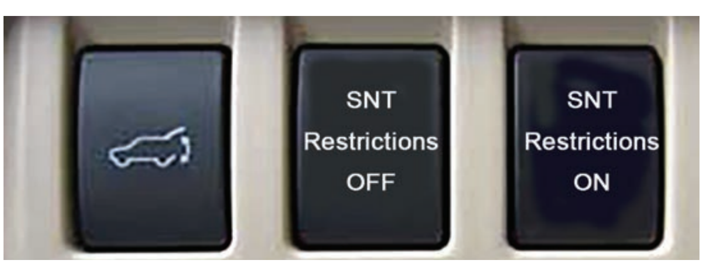
made decisions and we, the grandchildren, do not want to overrule them. In the world of Special Needs Trusts, more often than not, grandfathering does not apply. Why? Perhaps because it is the government's money, not the grandfather's assets, that will have an impact on the special needs of the beneficiary of the trust.

Special Needs Trusts

If you go to a lawyer and you are considering a trust for a person who has, or may have, special needs, they may recommend a restriction that would not allow the trustee to make distributions for food, clothing, shelter or health care that could be provided by government benefits or assistance. Well, the definition of government benefits or assistance is daunting, both federal and state: SSI, SSDI, Medicaid and state benefits. Sort of reminds me of my Subaru. These are benefits designed to reduce financial risks but they might actually create unanticipated risks. The complexities of a 1,000 page manual may have us drive in the wrong direction.

Let's say the person with special needs receives SSI, which currently is limited to $735 per month.[2] As trustee, I may be barred from paying the rent, directly or indirectly, for the benefit of the beneficiary. Even in Vermont, housing at this price may be very unattractive.

These are very complex rules in an environment that does not grandfather the rules. The SNT trust as designed today may be effective today, but not tomorrow. Trying to understand my Subaru manuals, which don't change, and SNT manuals that do, may have one thing in common: focus on key safety buttons.



The first button is to turn off the SNT restrictions. Here is an example of safety button one:

> "Notwithstanding the provision barring distributions that would diminish government support, the trustee may make distributions to meet the beneficiary's need for food, clothing, shelter or health care, even if such distributions may result in an impairment or diminution of the beneficiary's receipt or eligibility for government benefits or assistance."

This is the type of clause we should discuss with our attorneys. In response, the attorney may suggest a second button that will turn on the safety button if necessary. Here is an example of safety button 2:

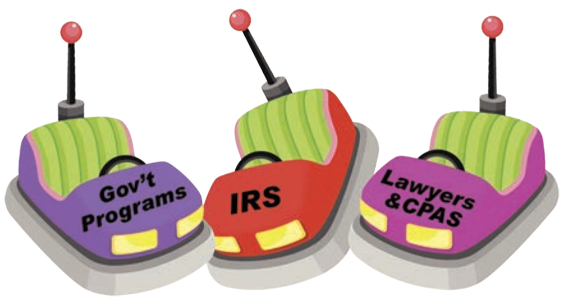
> "If the mere existence of the trustee's authority to make distributions pursuant to this paragraph shall result in the beneficiary's loss of government benefits or assistance, regardless of whether such authority is actually exercised, this paragraph shall be null and void and the trustee's authority to make such distributions shall cease."

The next question is: do you want the second button? The impact of saving dollars may have unanticipated consequences. My example above did not mention the risk of Medicaid benefits that might be vulnerable as well.

Estate Planning & Special Needs Trusts is still in its infancy. When I review Special Needs Trusts I see a field of expertise that is still in its adolescence. To all lawyers and their clients who use Special Needs

Trusts (or its sibling, a Qualified Disability Trust) as my grandfather might say, the legislators may pull the rug out from under you.

I like my Subaru. It is a safe car if I don't look at the dashboard screen too often. It is a solid car and would make a great bumper car. In the world of Special Needs Trusts, we have several bumper cars: those that administer the government programs, the IRS, and lawyers and accountants that do not prepare tax returns for trusts (a fiduciary tax return).



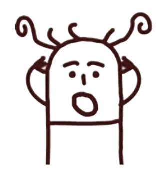
In the tax world, there are two types of Special Needs Trusts: The First Party Special Needs Trusts and the Third Party Special Needs Trust.

All income of a First Party Special Needs Trust will be reported to the IRS as if it had been paid to the person, even if the trustee made no distributions to the person with special needs.

The trustee of Third Party Special Needs Trust may or may not send a tax letter to the person with special needs, depending on whether distributions were made to or for the benefit of the person with special needs. The tax rules are different then the rules used by those who administer government programs, such as the Centers for Medicare & Medicaid Services (CMS). If the trust buys an iPad for the special needs person that costs $800 and the trust earns $800, then the special needs person will receive a tax letter saying he or she needs to report $800, assuming no other income or disbursements for the year. CMS will probably take the position that this is not income that will reduce the disability benefits. Fortunately, the two organizations talk to each other. But what about accountants and lawyers who do not do fiduciary tax returns? They might be inclined to suggest no disbursements for expenditures that would disqualify the person with special needs. That said, the income in the trust may be subject to a much higher tax rate in the trust. Often it is not as simple as it looks.

I drove my Subaru to an intersection having inadvertently set one of the safety buttons, and my car would not let me go right on a red light when the only traffic was on the left lane. I worried about the car behind me. Who was in the car? A lawyer? An IRS agent? Someone who works for CMS? Or those just prone to road rage?

I still love my back-up camera. But then again unanticipated consequences: a middle-aged man drove into our company parking lot with a car with the same back-up camera. My greeting started with how much I love the back-up camera and, "I am 90 years old when I back up" but I paused for just a second to finish with "but when I drive forward I am still 18". During the pause he said, "So you are 90?"



Endnotes

1 To those who were not raised in my household, this is a joke.

2 Notes to attorneys: the objective of the newsletter is to create a discussion. My example did not focus on the risk of Medicaid benefits. Payments on behalf of beneficiaries, rather than direct payments, may reduce but not eliminate benefits so the trustee can contribute enough to provide adequate housing. Button 1 does allow this. If you feel a need for button 2, you might be able to modify button 1 to allow for modest diminutions, but not impairment, and avoid button 2.