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Quarterly Update

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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

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Down Memory Lane with Portfolio Manager Steve Singiser

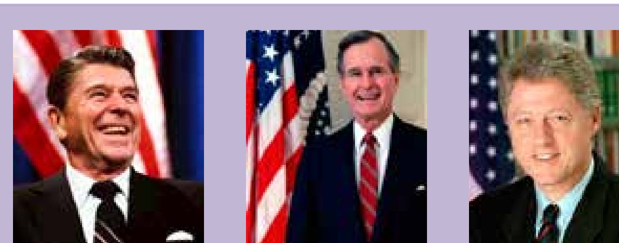
This article continues Steve's history of the stock market as seen through the lens of his working career: 1962 to the present. We pick up the narrative in the 1970s, up through the 1990s. The third and final installment in our October newsletter will cover the new millennium.

The Wonder Years

"The Wonder Years" was a terrific television series that ran from 1988 to 1993. Some of you may recall it was the story of Kevin Arnold and Winnie Cooper, two twelve-year-olds, coming of age during the late 60s and early 70s. In many ways its stories reflected that period in terms of our values, our darker moments and many of our enlightened moments as individuals and a nation. An amazing soundtrack moves each story and reminds us of a time many of you will recall. That was the period I wrote about in the previous article.

The Wonder Years I am writing about this month are the two decades, roughly twenty years, starting in 1981 and ending at the dawn of the new millennium, 2001. I am not sure what, if anything, should be made of the fact that the TV show aired right smack in the middle of this twenty year period. Perhaps the creators were nostalgic for a time when they came of age twenty years earlier.

Why choose that description for this period of time? For openers, Ronald Reagan was president the first eight years of the 80s and Bill Clinton for the last eight years of the 90s. These were two very strong, albeit different, individuals who were well-suited for the years they served. The truth of that statement might be debated by an honest Republican and an honest Democrat, but not here. During the intervening four years George H.W. Bush, the last president to have World War II combat experience, served with integrity and respect.



Obviously, there is more to be said about these particular Wonder Years and much of it has to do with the investment opportunities during that period of time. Did the presidents make the times or did the times make the presidents? My best answer is "yes".

1980 to 2000

During the two decades ending in 1999, the stock and bond markets created more wealth for individuals and corporations than during any prior period.

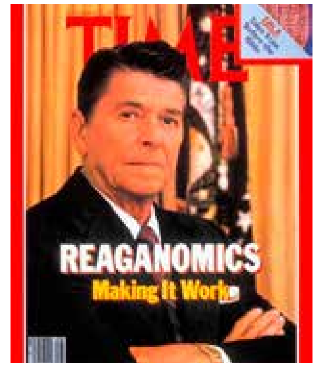
It was a great time to be an investment manager. I am reminded you didn't need to be overly smart or lucky to make good investments choices. Mostly, you had to show up and be a player.

You may recall the 70s being defined by an unpopular war, social unrest, a lackluster stock market, rising interest rates, and no real economic growth paired with high inflation (stagflation). It was a decade to put behind us. The 80s, on the other hand, were largely defined by a president with a great topical sense of humor and a 'can do' positive attitude; an accommodating Federal Reserve; lower inflation paired with declining interest rates; rising stock prices; and a strong economy.

The 80s -The Reagan Decade

> **"Mr. Gorbachev, open this gate."**
>
> **"Mr. Gorbachev, tear down this wall!"**
>
> **"The nine most terrifying words in the English langauage are: I'm from the government and I'm here to help."**
>
> **~ Ronald Reagan**

Ending the Cold War with Russia and shrinking the federal government were clearly his goals, as stated above. The end of the Cold War essentially began with the opening of the Berlin Wall to the West on November 9, 1989 followed by the domino defection of the Eastern European Soviet satellite countries over the next two years. His success at shrinking the government, however, was less clearly defined. It was based on President Reagan's economic policy, popularly named "Reaganomics", calling for widespread tax cutting, lower social spending, higher military spending, and the deregulation of domestic markets. Tax reductions and "Star Wars" spending led to large deficits, the impacts of which possibly extended beyond his term in office. Does the "trickle-down theory" sound familiar?



The Fed

There are two distinct ways the government tries to maintain consistent economic growth: fiscal policy through the United States Congress and monetary policy through the Board of Governors of the Federal Reserve System and its Chairperson, a position currently held by Janet L. Yellen.

The Congress approves and controls the annual spending budget. The budget can be expansionary during difficult times or restrictive during recovery times. Good luck with that! We all know how they get re-elected.

The Board of Governors and its Chair are appointed by the President and confirmed by the Senate. They can serve one fourteen year term. In theory they are an apolitical group and can act independently of the prevailing political climate. The Board of Governors have been granted many powers to deal with economic problems. Most of these involve taking action to control inflation. Inflation largely determines the direction of interest rate changes, bond prices, and home mortgage rates. Its powers include buying or selling large amounts of government bonds and raising or lowering short and long term borrowing rates. Sometimes just discussing the Board's intentions can have a huge impact on the bond and stock markets. Congress may be more than a little jealous of the Fed's independence and powers and perhaps takes it out on the Chairs, when they are called to appear at a hearing. Personally, I think the Fed's independence is a very good thing.

Having just said that, a somewhat erratic monetary policy in the early 80s led to two mini-recessions. However, soon the desired result of lower inflation and lower interest rates was successfully achieved, leading to a stimulated economy for the rest of the decade and beyond. The table was set for the next two decades of nearly uninterrupted double-digit annual returns from both stock and bond investments. Fiscal and monetary policies were working well together.

The Bond Market

In the April newsletter I discussed the historically rapid and unrelenting rise in interest rates during the 1960s and 1970s due to increasing inflation largely caused by higher energy costs. Remember, when interest rates rise, bond prices decline. By late 1981 interest rates finally peaked at around 15-16%, up from about 3% in the early 60s. Many bonds, particularly longer term bonds, were selling at a deep discount to their original face value of 100. Various U.S. Treasury bonds provided a yield to maturity of about 15%. Bond buyers who were brave could fix that return for the next 20 or 25 years in U.S. Treasuries - considered the world's safest investment. Coincidentally, bonds with shorter maturities, even money market funds, yielded almost as much and many bond investors shortened their maturities just at the time they should have locked in the higher rates for as long as possible. Few could foresee interest rates were peaking; many did not want to risk owning long bonds in case rates went higher. A once in a lifetime opportunity passed quickly. There may be some consolation in the fact that as interest rates decline, bond prices increase for a period of time and sell at a premium to their face value. Active bond managers use this to their advantage by trading their bonds. For over thirty years bond yields have been declining. See the chart below:

The Stock Market, 1980 to 1990

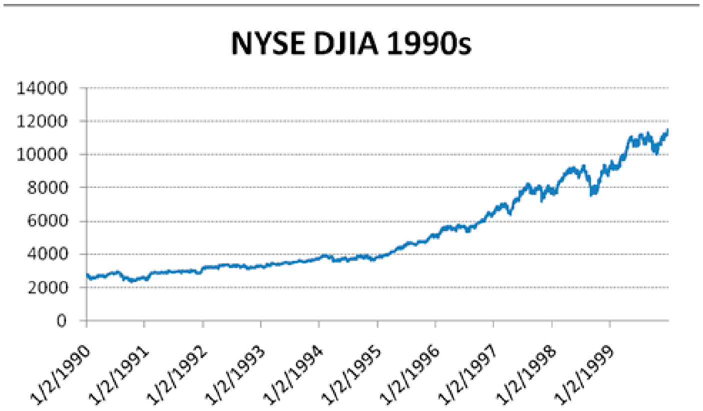
The Dow Jones Industrials rose from the 838 level to 2,753 during this ten year period, a gain of nearly 230%. In October 1982 the DJIA rose above 1,000 and has never looked back. The stock market was down in only two years: 1981 and 1984. Ironically, the worst one day decline in Dow history occurred on October 19, 1987, Black Monday. Programmed trading was believed to have been the culprit for the one day decline

of over 22%. Since then, trading safeguards have been put in place and seem to be working. Within a matter of days the stock market started rising again and went on to dramatic new highs.

The 90s – the Technology Decade

The Stock Market, 1990 to 2000

The Dow Jones Industrials rose from the 2,753 level at the beginning of the decade, to 11,497 at the end, a gain of over 315% for the final ten years of the good old 20th Century. Initially the collapse of our Cold War nemesis, the Soviet Union, was undoubtedly the single most defining event creating a renewed sense of optimism in the United States and the world. As the threat of global conflict rapidly diminished, a familiar theme reappears: military expenditures transitioned toward consumer products again. Advances in electronic devices gained traction as features improved and prices came down. It was the best of investment times with a combination of low inflation and a strong economy. The stock market recognized this and the DJIA reached 5,000 by November 1995; 8,000 in July 1997; and 10,000 in March 1999. Sometime around the 5,000 level many pundits



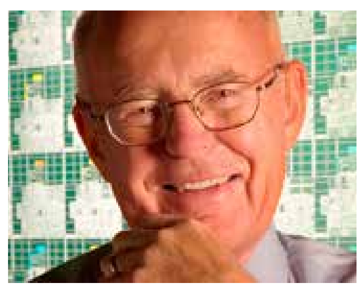
on Wall Street and off became worried that stocks were over-priced. But as the saying goes "Stocks climb a wall of worry". The DJIA had one last double in it before its next significant decline. In all honesty, at the turn of the century many stocks were seriously overpriced by any legitimate measure.

The Bond Market, 1990 to 2000

Interest rates continued to decline during this period. For example, 10 year Treasury bonds yielded about 8% in 1990, but only 5-6% at the end of the decade. Other issues behaved similarly.

Technology – Moore's Law

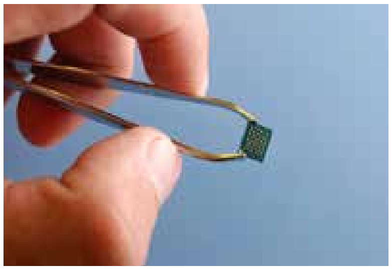
Can you imagine the 90s and the years since without the rapid advances in technology? If you even had one, do you remember what kind of computer you had in 1990, or what it looked like, or how many gigs it had - whatever that means? We owe so much of the growth in technology to a select few men of great vision. I am going to write about one of them here. You may or may not have heard of him.



His name is Gordon Moore and he is 86 years old. In 1965, when he was only 36, Mr. Moore wrote an article for Electronics Magazine, the contents of which has long since been named "Moore's Law". At that time he was head of research at Fairchild Semiconductor and later a co-founder of Intel. I have just learned this and what follows from a recent editorial by Thomas L. Friedman titled "Moore's Law Turns 50".

For the 1965 article, Mr. Moore was asked to predict the future of integrated circuits. "Moore predicted that every year we'd double the number of transistors that could be fit on a single chip of silicon so you'd get twice as much computing power for only slightly more money. When that came true, in 1975, he modified his prediction to a doubling roughly every two years. When asked about his predictions being so correct for so long, he replied: "The original prediction was to look at 10 years, which I thought was a stretch. "Moore's Law" has essentially held up ever since."

This was going from about 60 elements on an integrated circuit to 60,000 - a thousand fold extrapolation over 10 years. I thought that was pretty wild. The fact that something similar is going on for 50 years is truly amazing.



Quoting from the editorial itself: "Intel's latest chip offers 3,500 times more performance, is 90,000 times more energy efficient, and about 60,000 times lower cost."

Lastly, here is a lengthy quote from the Friedman editorial that I find almost unbelievable. I remind you this was written in 1965:

> "What is most striking in Moore's 1965 article is how many predictions he got right about what these steadily improving microchips would enable. The article entitled "Cramming More Components Onto Integrated Circuits" argued that: "Integrated circuits will lead to such wonders as home computers – or at least terminals connected to a central computer – automatic controls for automobiles, and portable personal communications equipment. The electronic wristwatch needs only a display to be feasible today. In telephone communications, integrated circuits in digital filters will separate channels on multiplex equipment. (They) will also switch telephone circuits and perform data processing."

You just can't make this kind of thing up!

In the interest of time and space, I have purposely left out events or topics that also contributed to making the 80s and 90s "The Wonder Years". As a footnote, I believe many of the economic policies initiated in the 80s had their largest impact in the 90s. Huge government deficits evolved into huge government surpluses, as the United States enjoyed a sustained period of low inflation and high economic growth. Fiscal restraint was no longer a viable policy in the minds of many in Congress, a mindset that continues to the present. Thanks to the Fed, there are alternatives to cool off inflationary periods.

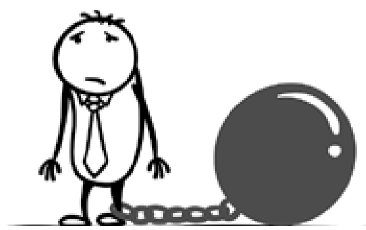
In any case, the 20th century ended well. Our primary concern seemed to be whether our PCs would work in the new millennium because of its built-in calendar. Not a problem. Most of us were fairly optimistic about the future. Fortunately, we could not imagine what lay ahead.

New Location for our Rutland Office

We have moved our Rutland Office a few blocks away from the Service Building to 23 Court Street, a historic Rutland landmark. Our new space will offer staff and clients more room, improved accessibility and easy parking. Jeanne Gilbert, Bonnie McLellan and Steve Singiser look forward to seeing you there!

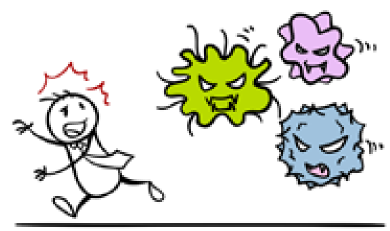
Who is taking advantage of the elderly? Scoundrels and public servants

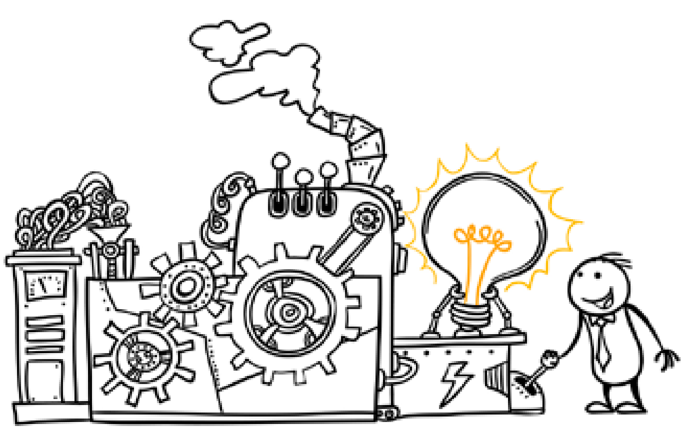
I like to prepare my own income tax return. I am not sure why. My first full-time job was as a tax editor. It wasn't a good match. I sat in a cubicle and summarized long and tedious cases all day long. It felt like a work release program in reverse and the Warden was the IRS.



My second full-time job involved understanding tax law. Understanding tax law is not easy and I suspect that at some point I would have left my second full-time job mid-career if the "PC" (a Commodore) had not arrived.

The PC matched my personality. Buy a program and do a tax return. Simple. In those days programming was complex but the tax laws were less complex. If the computer code is good, the tax return tells all. Prose and math and the collision of semantics often is not helpful in understanding tax consequences. "If you convert your IRA you may go into a new bracket." Sounds ominous. Many people think that going into a new bracket will expose all the income to the new, higher, bracket. Not so...just newer income to the higher bracket.... but what about all those other adjustments that relate to income? Frightful.





Just enter the numbers into your tax program and see the results and then make your decision. So simple! Then the tax laws and regulations, as we say in my youth, went bonkers. And perhaps the underfunded IRS went bonkers as well.

A few years ago, before my symptoms of paranoia had started to emerge, I started to see a change. It was April 14th and I headed to the post office to file my tax return. A colleague says: "Get a 'Return and Receipt'". I said, "Why..... the envelope will show the posting date?" She said, "Get it". I took her advice. A month later I received a late filing fee. They must have lost my envelope! But I had the evidence and the problem was resolved.

Then, tax information forms started to change. The 1099-B started reporting cost basis on sales for some, but not all sales. Health Savings Accounts became more complex. Retirement benefit reporting became more complex. Nonetheless, I was still confident that

I could stay ahead of the changes in the tax laws and the resulting complexities. Then I got caught! A big deficiency bill with big penalties arrived. For the first time, I felt fear. Maybe if I were younger I would simply say “calm down…it’s not like the four foot putt to win the game for your team…and you three-putted”.

I had moved my IRA from one account to another and my Trustee, the Trust Company of Vermont, sent me a 1099R. I don’t fault the Trust Company of Vermont but sometimes I wonder whether they should have told me “You better report this or you will go to jail”.

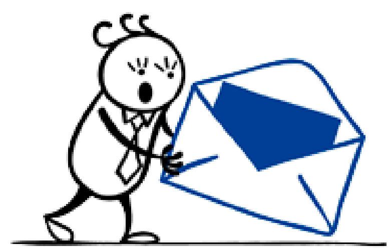
I didn’t report it. Now in my defense, there was a “G” code on the 1099R that told the IRS that it was a non-taxable rollover. So the resolution was in my favor and I learned something important in dealing with the public servants at the IRS: FEAR.

I know the IRS staff wants to be good public servants, and I can understand the stress of being underfunded while dealing with Trolls who are stealing social security numbers and filing tax returns asking for refunds.

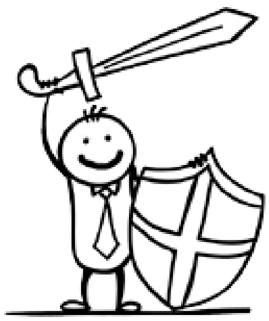
Fear is the weapon of those who will try to steal your money; thieves who call the so-called “elderly” pretending to be from “THE IRS” demanding money. The IRS does not call. They only send deficiency notices. We have not yet experienced a phony tax deficiency letter with a number to call. If you do receive one and call the number, and someone answers within a few minutes, it is probably a scam. When you call the IRS, the minimum wait will be approximately 45 minutes…and then they might transfer you to another department and you will wait another 45 minutes…or, if they are too busy, they will simply disconnect you with a message that says for you to call later.

It seems like deficiency notices are growing at an accelerated pace. A client sold their house at a loss. The broker sent a tax notice and the IRS sent a letter claiming approximately $100,000 in tax and penalties. We have a growing list of stories like this. Sometimes the party that sent a tax notice prepared the notice incorrectly. Sometimes the IRS made the mistake. Often no taxes and penalties are due, but the notice and the process of dealing with the IRS prematurely ages our clients.

We also have a growing concern that the State of Vermont may not be far behind the IRS. Recently one of our clients, active and healthy, discovered that the executor of her estate received a letter from the Vermont Department of Taxes telling the executor that she died in 2011. Fortunately, it is easier to deal with the State and, in this case, the client felt comfort in her diagnosis rather than the State’s assessment.



We need to protect the “elderly”. So to the IRS, I say you need to do a better job of protecting the “elderly” lest they simply send you the money once they receive the delinquency letter from you. I know you mean well and when we are able to talk to a person, we know your pain. You have wardens too.



Whether you consider yourself "elderly" or like many of us folks who simply feel fear regardless of age, share the pain quickly. If you do get a notice, don't worry. Just call your accountant or tax preparer, or call us. I, for one, am not afraid of the IRS.

John Doe

P.S. As I was adding the finishing touches to this newsletter, one of our trust officers was unavailable. She just received a tax deficiency tax letter asking for approximately $34,000. The IRS once again was wrong. She aged another year nonetheless.

"The I.R.S. can't hurt him anymore."

When and How to Deal with Your Public Servants at the Social Security Office

Software is still the best solution in making the right decision in electing Social Security. If married, the Social Security elections are very complex....and should be considered well before either spouse turns 62. It is mind-boggling and good software is essential. Here are your options of when to take benefits based on the ages:

62/62
62/66
62/70 + Spouse Spousal
66/62
66/66
66/70 + Spouse Spousal
70/62
70/62 + Primary Spousal
70/66
70/66 + Primary Spousal
70/70
70/70 + Primary Spousal
70/70 + Spouse Spousal

The right decision may depend on such things as a "restricted application" for a spousal benefit, "claiming and suspending" a benefit to make a spouse entitled to a spousal benefit on the other spouse's work record, and modeling future "survivor benefits" based on an assumed year of death of one spouse.

Our recommendation to our clients:

First and foremost: we can run the software for you. Then we suggest that you take the projections into the Social Security office (do not call them). Do not use the Social Security website. Just visit with a public servant in person and they will take care of you.