# Trust Company *of* Vermont Quarterly Update JULY 2022

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## Perspective from the President

*Chris Cassidy, CEO*

Thanks to the wise advice of my Trust Company colleagues, I immediately opened a Roth IRA when I started full-time here in 2006. Unfortunately, the apartment I was renting in Burlington was not cheap, and finding funds to contribute to a retirement account was not always easy. Cutting expenses where I could, I began contributing whatever small amounts that were freed up.

When I began my career, The Standard & Poor's 500 stock index traded at 1,280. Today, the S&P 500 trades at about 4,000. In hindsight, I should have spent less and saved more in those early days, but I am glad I contributed what I did.

The Individual Retirement Account (IRA) was introduced as part of the Employee Retirement Income Security Act of 1974 and was made popular with the Economic Recovery Tax Act of 1981. The Roth IRA was created by the Taxpayer Relief Act of 1997.

With a Traditional IRA, contributions are made with pre-tax dollars. The assets grow tax-deferred, and withdrawals are taxed as current income. With a Roth IRA, contributions are made with after-tax dollars. The assets grow tax-free, and withdrawals are tax-free.

Since the time of their creation, the growth in both Traditional and Roth IRA balances has been tremendous, due to both contributions and long-term investment growth. According to the Survey of Consumer Finance (SCF), in 2019 there were $9.4 trillion worth of assets in Traditional IRAs and $1 trillion worth of assets in Roth IRAs. Furthermore, over 11 million taxpayers made either Roth or Traditional IRA contributions in 2019.

Many individuals retiring today began work in the 1970s and 1980s and have been contributing to retirement accounts for much of their working careers, and many individuals have a significant amount of their overall wealth invested in these retirement accounts. Understanding how Traditional IRAs and Roth IRAs fit into estate planning–as well as the rules surrounding distributions and payouts–is very important.

Fortunately, Trust Company of Vermont has several professionals with extensive knowledge about the rules and regulations inherent in IRA administration. One such professional is Kasey Franzoni, who has written a very timely article about inherited IRAs and payouts. Kasey already had extensive trust experience when she was hired by Trust Company of Vermont in 2019. Since joining Trust Company of Vermont, Kasey has also obtained the Certified IRA Services Professional (CISP) designation. Kasey is a fantastic resource for employees and clients. A longtime resident of Rutland, she lives there with her husband, Peter.

## Staying in the Game

*Tanner Freeman, Portfolio Manager*

When I was growing up in Vernon, Vermont, my family and I attended a few UMass-Amherst basketball games a year. During uncompetitive games, a favorite strategy of my dad's was to leave a few minutes before the final buzzer in attempt to beat the crowd out of the stands. One night, UMass played its rival Boston College in a close game, until BC pushed its lead to 8 points with 45 seconds left. My father exclaimed that the game was over. Keys in hand, he led us to the door. Of course, he was not alone in this decision, as other fans had the same thought in mind. While we were racing other attendees to our respective cars, a group of college kids drove by, exclaiming the game was heading into overtime and honking their horn as they peeled away. We turned on the radio to find UMass had indeed mounted a late game comeback to push the game into overtime! Not only had we missed a great ending, we didn't beat the traffic, and we had to listen to the final minutes in the car.

As of the time of this writing, the S&P 500 Index was down 13 percent year-to-date. Investors certainly have headlines to worry about. Global supply chains continue to be backed up, a war is raging in Eastern Europe, and price inflation not seen for four decades is worrying the world –all motivating many investors to make an exit from the stock market, at least temporarily.

During periods of heightened volatility, it is natural for investors to think about selling securities in hopes of buying them back later at lower prices. Much like my father thinking he can beat the crowd, some investors act too soon in trying to avoid or minimize market declines. Unfortunately, human beings are not very good at predicting near-term outcomes. Even professional economists and market strategists have a poor track record of correctly predicting what will happen in the next year or two.

It is important to understand market history at a time like this. We know it is not uncommon for pull-backs to occur. During the past 42 years, the average intra-year drop in the S&P 500 has been 14 percent. However, in those years the index has recovered 76 percent of the time and ended in positive territory.

In the short-term, market direction relies heavily on investor psychology, not the quality of businesses that underlie their investments. A study done by JP Morgan analysts looked at data from January 2000 to June of 2020. They found that eight of the best 10 days in the market happened within two weeks of the 10 worst days. That is to say, investors became optimistic shortly after being their most pessimistic. While this is a great example of the behavioral aspect of markets, the true lesson comes from the consequences of attempting to by-pass market volatility. During that 20-year period, a $10,000 investment grew to be $26,067. Yet, if investors attempted to predict short-term fluctuations and missed just 10 of the best trading days, their investment grew to only $12,031. The best 10 days of market activity accounted for more than half of returns in a 20-year period. Shockingly, by missing the best 20 days, investors had a negative return over that period.

At Trust Company of Vermont, we take a long-term view to help clients reach their financial goals. Apart from knowing short-term predictions are futile, we have observed that their consequences can be destructive for long-term returns. With an understanding of history – and of course by carefully choosing and following high-quality stocks – we believe that staying in the game during volatile periods offers the best chance for long-term success.

# IRA UPDATE 2022

*Kasey Franzoni, CISP & Trust Administration*

## *The New IRA SECURE Act Proposed Regulations and the Impacts on the 10-Year Rule*

In December 2019, Congress passed the "Setting Every Community Up for Retirement Enhancement Act" – more commonly referred to as the "SECURE Act".

Under this Act, the Life Expectancy Payout was removed as an option for all non-spouse inheriting IRA beneficiaries and replaced by the new 10-Year Rule. Under this rule, beneficiaries had 10 years from the year of death of the original IRA owner to distribute the balance and close out the IRA. There was no outline of any distribution schedules for these beneficiaries to follow, only the direction that they must empty the IRA account by December 31st of the 10th year following the year the IRA owner died.

On February 23, 2022, the Internal Revenue Service released their Proposed Regulations to the SECURE Act and their interpretation of how the 10-Year Rule applied to certain IRA beneficiaries. For IRA owners who were required to take RMDs before they died, their respective 10-Year Rule beneficiaries now must continue that distribution schedule for years 1-9 (of the 10-year period) and deplete the account by December 31st of the 10th year. This is referred to as the "ALAR" or the "At Least as Rapidly Rule." The annual distributions are calculated based on the beneficiary's life expectancy.

For those Inherited IRA beneficiaries that were subject to the 10-Year Rule and the ALAR after January 1, 2020, the Proposed Regulations (once enacted) could require such beneficiaries to take both their 2021 and 2022 RMDs by no later than December 31, 2022.

Please note: if you are a non-spouse beneficiary of an IRA owner who died after January 1, 2020 but before age 72, they were not required to take annual distributions. Therefore, the original 10-Year rule will apply to your payout situation.

We're following this closely and will notify all our impacted Inherited IRA clients when we receive further clarification from the IRS. A more comprehensive explanation of this topic will be included as an insert with your June 30 account statement. If you have any questions or concerns, please don't hesitate to contact us.

# The Quality of Competitive Advantages

*Paul Copeland, CFA & Portfolio Manager*

My father often told me it's better to buy high-quality equipment and take good care of it than to just buy the cheapest option. I learned the hard way that he's right, and I have a shed full of junk to prove it. Meanwhile, the John Deere tractor and everything else in his garage works perfectly—as it did when I was a kid.

At Trust Company of Vermont, we value high-quality investments. One criterion we use to evaluate company quality is "economic moat." This is a term popularized by Warren Buffett for competitive advantages, which protect companies' profitability—just as castles were built with moats to help protect against invaders. We look for companies that protect their profit margins for years to come. The length of time is especially important in taxable accounts, where gains can compound tax-deferred when they stay in the same stock.

While we diversify investments among many sectors to reduce overall account volatility, we see more wide-moat companies in some industries than in others. Later, I'll explain what types of moats companies can build, but first it's important to realize that the industry is often a factor on a company's economic moat. In 1979, a now famous associate professor, Michael Porter, wrote an article in the Harvard Business Review titled, "How Competitive Forces Shape Strategy." Porter's Five Forces, introduced in that article, help me evaluate industry structures that lend toward higher profitability. The first four – buyers' bargaining power, suppliers bargaining power, threat of new entrants, and threat of substitutes – lead to the fifth, which is of great importance: rivalry among existing firms. These forces help explain why we find more high-quality companies concentrated in some industries—and avoid others.

For example, there are no airlines on our approved list of

stocks. The airline industry is near the worst for profitability measured by return on invested capital. Through the lens of Porter's Five Forces, we see that: 1) buyers can easily price shop airline tickets and most always do; 2) Airplane suppliers are a duopoly with just two firms, Boeing and Airbus, controlling the market; 3) While there are some significant barriers to entry (planes are very expensive and there are only so many gates at each airport), low-cost airlines can start with just a few routes (Breeze and Avelo are two recent examples); 4) Substitutes are available with automobiles, trains, and the recent widespread use of videoconferencing. These forces lead to rivalry among airlines so that even the best managed, like Southwest, have trouble consistently earning a decent return on capital. Other industries are on much softer ground in which a company can construct a moat.

*The high-quality companies we often buy have established moats, so I spend less time looking for companies that might build a moat and more time analyzing whether a wide-moat company is maintaining its competitive advantage.*

There are reasons why you might not own a wide-moat company. Maybe it has a high valuation, doesn't pay the dividend you want, or doesn't line up with your personal values. Amazon is a stock that's not for everyone, but it has been building a wide moat that should allow it to grow profits for many years to come. Here are the main building blocks of Amazon's moat:

1. **Intangible Assets:** Amazon had over 2,200 patents granted in 2020, but I see its brand as a much more valuable intangible asset. Buying online requires trust. I've been burned online before, I don't even compare prices like I used to. Although it's easy to compare prices online, it's often not worth the risk of a bad experience.

2. **Cost Advantage**: Amazon has efficient scale with technology, so it can sell at a lower price and still make more money than competitors. I made a mistake in a purchase the other day. What probably would have taken a phone call to a customer service agent and a bit of work and cost for another merchant was corrected with a few clicks of a button at Amazon.com.

3. **Network Effect**: More than half of the sales on Amazon are made by third parties. Merchants are attracted to sell on Amazon because of the many buyers. More sellers bring more products, which attracts more buyers. And more buyers attract even more sellers, etc. This network effect is so powerful that more product searches are now started on Amazon than even on Google. This strength shows in that Amazon had $31 billion in advertising sales for last year.

4. **Switching Costs**: I'm not a member of Amazon Prime (Amazon's premium membership service, offering several services, such as free shipping, for an annual fee) but there are 200 million Prime customers who are incentivized to choose Amazon over other on-line merchants by the shipping benefits they get. The costs of switching are even more apparent in Amazon's most profitable division, Amazon Web Services (AWS). Roughly a third of the activity on the internet takes place on AWS-hosted sites. If a company has its data on AWS, it's more likely to use the AWS tools for analyzing and securing that data. Switching from a cloud provider can be a very difficult transition if a customer is relying on many of the AWS specific tools.

You might wonder if my holding period for Amazon stock is forever since I see a wide moat that should protect its long-term profitability. I would agree with its founder, Jeff Bezos, who said, "Amazon is not too big to fail…In fact, I predict one day Amazon will fail". Moats in many medieval castles have dried up, and they wouldn't protect inhabitants from even a small modern army these days. Likewise, many businesses lose their economic moats over time as high profits attract competition or the world changes. I saw this last year when our family visited the Strong's Museum of Play in Rochester, NY, as part of a vacation to bicycle short parts of the Erie Canal Rail Trail. The museum is a creative gem that I most highly recommend to anyone, but Rochester was different than I expected. The city was home to Xerox and Eastman Kodak, imaging industry giants of the 20th century. Both had wide moats around their businesses that were decimated by changes in technology. Rochester was left with some magnificent buildings, but it has been struggling for over two decades to recover from the titanic commercial decline of those once thriving companies.

The high-quality companies we often buy have established moats, so I spend less time looking for companies that might build a moat and more time analyzing whether a wide-moat company is maintaining its competitive advantage. We often find that our investments have economic moats that are more stable than their daily stock prices, but over time stock prices follow higher profits allowed by wide moats, so we stay with the same investments for years.

At Trust Company of Vermont, we seek opportunities where we have a competitive advantage over other investors. Investing patiently in great businesses with strong economic moats is to our clients' advantage. Most investors focus on short term price movements, the quarterly whisper numbers, breaking news, or quick-riches fads. Durable economic moats build wealth more slowly, so we have less competition as investors. A company might decide to sacrifice some profit this quarter to invest for future gains. People concerned mainly about the short-term will sell, which can create opportunities for us to buy into a business that will run (like my dad's Deere) for many years to come.

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