Trust Company *of* Vermont
Quarterly Update

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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester

Employee-owned & Vermont-based www.tcvermont.com

Chris Cassidy, CEO

WHEN I STARTED MY freshman year of college, I opened an Ameritrade Account. I had worked hard all summer and had accumulated enough savings to start investing. My major problem was that I knew next to nothing about investing at the time.

I began my college career planning to double major in English and Political Science. Although I enjoyed reading Geoffrey Chaucer and Alexander Hamilton, they offered me very little in the way of investing advice. I naively assumed that I could skim through an investment book in the library and instantly become a stock market guru, so I picked up a copy of Peter Lynch's ***Beating the Street.*** In that book, Lynch's Principle #14 was ***"if you like the store, chances are you'll love the stock."*** Lynch noted that he would drive to his local mall and see what stores and products consumers were gravitating towards.

That concept sounded very simple to me, and I decided to observe the student body and purchase stocks based on their behavior. Most students in those days had large clunky Dell desktops in their dorm rooms powered by Intel processors. Also, many students were starting to purchase a relatively new device known as a cellular telephone, and Nokia was a popular brand (these were the days before iPhones). In addition, I noticed a lot of empty Bud Light cans on campus when I would go to the gym on Saturday mornings. Consequently, I decided that I could simply buy a three-stock portfolio of Intel, Nokia, and Anheuser-Busch.

Unfortunately for me, all three stocks under-performed the broader market. Fortunately for me, I began taking finance, accounting and investment classes and learned about valuation techniques, security analysis and diversification. As I applied these concepts to my own portfolio, the performance greatly improved.

When we hire portfolio managers we seek individuals that understand fiduciary investment management and the importance of diversification. We also seek individuals that care deeply about their local communities and enjoy being part of a locally-controlled, employee-owned company. This past year, we were fortunate enough to hire Ian Estabrooks to be a portfolio manager for the Rutland and Manchester regions. Ian has 15 years of investment experience and a Chartered Financial Analyst (CFA) designation. Ian is a native Vermonter and currently resides in East Dorset with his wife Alicja and their two children.

Ian has written an article for us this month on the benefits of diversification. Fortunately for his clients, he understands that a three-stock portfolio is not a prudent investment strategy.

The Importance of Diversification

Ian Estabrooks, CFA & Portfolio Manager

EACH SUMMER AFTER SCHOOL GETS OUT, we send our kids to a variety of summer camps. I vividly remember one hot and humid afternoon when I was picking up my six-year-old son Sam from soccer camp. He was happily walking along, carrying his water bottle and backpack, and gently kicking his ball. When he saw me, his face lit up. He came running over and proudly pulled a one-dollar bill from his pocket. When I asked where he got it, he told me that he sold his bag of goldfish to one of his friends. I chuckled and patted him on the head and said, "that's great, make sure you put it in your piggy bank when you get home." The very next day he came home with twenty cents. I asked if he sold another bag of goldfish, but he informed me that he sold two Cheetos for ten cents each. Apparently, the full bag of Cheetos was too precious to give up completely. I applauded his entrepreneurial spirit, and gently reminded him that it's okay to share his snacks with his friends too. Over the next two weeks he attended an art camp and would occasionally come home with a nickel or a quarter, and sometimes even a dollar. Although, he complained that on days when we sent him with a healthier snack option he had a hard time finding demand for it. This is when he began making and selling his artwork to his friends. I was impressed by his drive, and even more impressed that he diversified his product mix to meet his "customers'" demand.

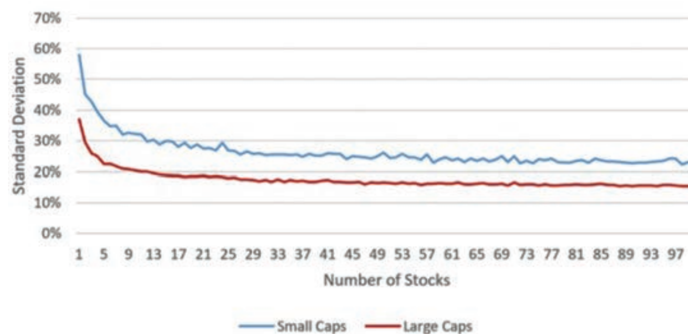
Diversification can be a very powerful tool when it comes to your investment portfolio. In essence, diversification is owning investment vehicles that behave differently from one another. A good example is comparing a bond to a stock. During times of economic growth stocks tend to outperform bonds, but during times of economic uncertainty bonds typically fare better than stocks. Holding riskier assets like stocks and safer assets like bonds together in a portfolio can lower volatility and provide an investor with a "smoother ride" during turbulent market events. It is important to consider a diversified asset allocation mix, as it can be customized to meet the risk/return needs of individual investors. However, in this newsletter I am taking a closer look at the diversification benefits, specifically within the U.S. equity asset class.

As mentioned earlier, stocks behave much differently from bonds, and they also behave differently from one another. Therefore, it is beneficial to own a portfolio of stocks, rather than just a single investment. The relationship that two investments have to one another is known as correlation. If two stocks were to move in the same direction, they have positive correlation. A value of 1 represents perfect positive correlation. On the other hand, if they move in opposite directions, they have a negative correlation. A value of -1 represents perfect negative correlation. The below table is a correlation matrix comparing the five year returns of four stocks to one

another. The first two are Exxon Mobil and Chevron, two of the most well known oil majors. It's no surprise that the correlation of their stock returns is 0.89. This number signals that historically the two stocks have traded similarly. There are several reasons for this. They have very similar business models, they are large-capitalization stocks, they both are headquartered in the United States, the price of oil greatly impacts their profitability. The list goes on... The next two stocks are Adobe and Microsoft, two very well known technology companies. Like the two energy companies, ADBE and MSFT also have a relatively high correlation to each other. But the correlation between the energy and technology stocks is much lower. As you can see in the matrix below, Adobe and Chevron have a correlation of just 0.23. Intuitively this makes sense as they operate completely different businesses and are affected by different factors.

Name	Ticker	XOM	CVX	ADBE	MSFT
Exxon Mobil	XOM	1.00			
Chevron	CVX	.89	1.00		
Adobe	ADBE	.33	.23	1.00	
Microsoft	MSFT	.46	.37	.78	1.00

But how many stocks should you own to have a well-diversified portfolio? Mathematicians have been debating this for decades, and the number seems to fall somewhere between 10 and 40 stocks, within the large-cap equity space. A study by the CFA Institute suggested that diversification benefits are limited within large caps after constructing a portfolio of 10 stocks. Their research showed that the average standard deviation (measure of volatility) for a 10-stock large cap portfolio was 20%. A more diverse portfolio of 40 large cap stocks had an average standard deviation of 17%. So, adding more large cap stocks to a diversified portfolio has a diminishing impact to diversification. While this was true for large-cap stocks, their research found that small cap portfolios benefit more from larger numbers of holdings. When moving from a portfolio of 10 small cap stocks to 40, the average standard deviation changed from just over 32% to 25%. The affect on the small cap portfolio was more than double that of their large-cap peers. The below graph illustrates the CFA Institute's findings.



Source of CFA Research and graph: CFA Institute, Peak Diversification: How Many Stocks Best Diversify an Equity Portfolio? By Aidan Eccles, Lindsey Coffey and Derek Horstmeyer

The takeaway is that diversification is important, but you don't need a massive portfolio of stocks to achieve your goal. However, it does matter what stocks you pick.

It would not be prudent to own a portfolio of only technology stocks, or only energy stocks. Diversification across sectors is just as important. A well-diversified portfolio should hold stocks in most or all the 11 Global Industry Classification Standard sectors. This helps to mitigate idiosyncratic risk that can be caused by factors that affect specific industries/sectors. For example, stocks in the energy, utilities, and materials sectors are greatly impacted by changes to commodity prices, and bank stocks are affected by changes to interest rates. Each sector performs differently from one another, so it

is important to achieve sector diversification. Similarly, it is also important to have diversification across different market-capitalizations. Adding small and mid-cap stocks to a large cap stock portfolio provides further diversification benefits, as they are impacted by different factors. For example, large cap stocks often do business globally, and can be affected by changes to foreign exchange rates or geopolitical challenges. U.S. small cap stocks tend to operate within the borders of the U.S. and are more insulated from global factors. The below correlation matrix shows the relationship between U.S. large cap, mid cap, and small cap. They certainly have a strong positive correlation to one another, but there is still some diversification benefit from combining them.

Name	Ticker	VOO	IVOO	VTWO
Vanguard S&P 500 ETF (large cap)	VOO	1.00		
Vanguard S&P Mid-Cap 400 EFT(mid cap)	IVOO	.93	1.0	
Vanguard Russell 2000 ETF (small cap)	VTWO	.88	.97	1.00

In conclusion, a well-diversified portfolio can help to reduce risk and improve risk-adjusted returns over the long-term. So, whether you're hawking snack time treats to your camp buddies or building an investment portfolio, consider the importance of diversification.

Congratulations to **Kasey Franzoni,** administrator in our Rutland Office, for earning the Certified IRA Services Professional (CISP) designation. She joins administrator Jeanne Gilbert in this credential, which demonstrates advanced study and expertise in regard to the complicated rules and strategies for IRAs.

A Ticking Time Bomb for those who may be "Well Off"

The House Ways & Means Committee just released a draft of a major tax bill. While the outcome is still uncertain, you may need to call your tax expert now. **If you meet the criteria below, steps may have to be taken before year-end.**

Estate Taxes

- Single Taxpayers with estates above 6 million*
- Married couples with estates above 12 million*

High-Earners and Roth IRA Conversions:

- The proposal eliminates next year conversions of traditional IRAs to Roth IRAs for high earner taxpayers.**

**Including prior gifts*
*** $450k per year filing jointly, $400k filing as single, and $425k filing as head of household*

Dealing with the Inherited IRA 10-Year Termination Rule

Chris Chapman, CTFA &Trust Administrator
Jennifer Rowe, Esq., Trust Administrator

Last year's new termination rule on Inherited IRAs may have been lost in the turbulence of Covid-19, the severe recession and elections. But it is worth exploring again because so many people have so much of their life savings tied up in tax-deferred accounts.

Recall that a beneficiary of a tax-deferred account must roll over the assets to an Inherited IRA – unless he or she is a surviving spouse (who can treat the IRA as his or her own and avoid the Inherited IRA rules). Until 2020, non-spouse beneficiaries could take distributions from an Inherited IRA based on life expectancy. Doing so allowed them to stretch out those distributions (and the resulting tax) over a period approximating the rest of their lives.

The Problem

Congress' 2019 SECURE Act made a major change with far-reaching tax consequences. The good news is that the new law exempts most non-spouse beneficiaries from having to take annual distributions. However, it requires that Inherited IRAs created after 2019 terminate entirely after ten years and distribute their contents to the beneficiaries. There are exceptions for spouse beneficiaries, disabled persons, and a few others, but most non-spouse beneficiaries have to anticipate paying income tax on the entire value of the Inherited IRA within ten years.

Non-spouse beneficiaries have some choice in the matter. They can withdraw some amount each year, avoiding a large distribution years later that might push them into a higher tax bracket, or they may defer the tax consequence as long as possible and wait until reaching the termination date. Either way, the tax consequences can be uncomfortably large.

A Solution

For those who want to leave their IRAs in trust for someone as a lifetime benefit, the ten-year termination rule and its tax consequences do not disappear. On the contrary, any undistributed income in an irrevocable trust is subject to compressed tax brackets, resulting in higher tax rates affecting a greater proportion of income.

However, in certain circumstances, an unusual application of a kind of charitable trust can avoid the increased tax burden of a ten-year distribution time period and preserve a distribution stream for the rest of the intended beneficiary's lifetime. The idea is to name a charitable remainder unitrust as the IRA's designated beneficiary. Such a trust, known in short by its acronym – a CRUT – is designed to benefit one or more individuals over their lifetimes and then distribute outright to one or more tax-exempt charitable organizations.

"But wait," the owner of a retirement plan account may say, *"why would I use a CRUT, knowing that my accumulated wealth will go to charity – and not be available to subsequent generations?"* It is true that the assets in a CRUT can benefit only the beneficiaries who are living at the time of

the CRUT's creation. However, the lifetime distribution stream may provide even more benefit than the IRA. Hence, the CRUT is attractive for people who have charitable intent, and it is also a tax-favored method to provide for the actual lifetimes of one or more loved ones, whether the grantor's spouse or the next generation (or both), before benefiting a charity.

Why It Works

Here's how a CRUT provides benefit. The IRA owner creates a CRUT, which is a kind of irrevocable trust. It does not have to be funded until the IRA assets are transferred to it (but it can already be in place and funded with other assets). A charitable deduction is available, which is the calculated value of the eventual gift to charity.

The tax on any IRA money that has been left to the CRUT is spread out over the time it takes to distribute an amount equal to the value of the IRA. There are some limitations on the distribution rate to consider, but at a typical 5- or 6-percent distribution rate, it is possible to slow down the IRA distribution – and spread out the tax burden – over a long period of time, creating a stream of cash resembling the old life- expectancy time period that the SECURE Act eliminated.

It is also possible that the beneficiary, if he or she lives long enough, will end up receiving not only the value of the IRA over the course of time but additional cash as well if the portfolio continues to be productive by way of income and appreciation of its investments.

There are limitations, however, which mean that a CRUT will not be appropriate in every case:

- The strategy risks the possibility that the beneficiary will not live long enough to receive distributions equaling or exceeding the value of the IRA.
- The rules for setting up a CRUT require that the value of the calculated charitable remainder be at least 10 percent of the amount contributed to the trust. This imposes limits on the distribution rate and also on the age of the beneficiary. If the distribution rate is too high, or the beneficiary's life expectancy too long, the amount left over for charity will not be enough to meet the rule. Practically speaking, this means a child of the IRA owner is a good candidate as beneficiary, but not a grandchild.
- The beneficiary will have no access to the trust other than distributions at the predetermined rate, even in an emergency. The CRUT provides less flexibility than a typical lifetime-support trust.
- There is investment risk involved. The investments within the CRUT will need to be productive enough to meet the desired cash distribution stream. However, the risk is mitigated when the portfolio consists of a well-diversified set of high-quality investments held for the long term.

In sum, the new Inherited IRA 10-year termination rule is a serious matter for those with substantial IRA or other tax-deferred retirement plan assets. But charitably inclined IRA owners may find that a CRUT is a useful means to work around it.

Please call us with any questions you may have about these strategies.

Batteries

Jack Davidson

The Prius and the Trust Company of Vermont arrived in the same year. Based on my perspective, we have much in common.

The Prius has become synonymous with the term "hybrid". In 2021, it is the most popular HEV ("Hybrid Electric Vehicle) ever produced. Shortly after its arrival in 2000, it was my understanding that my wife wanted a Prius. It was not my idea, or so I think. Her view was that it was a collaborative process, much like the 8 founders of the Trust Company of Vermont.

When we purchased the car, we made assumptions. The life expectancy of the typical car was relatively short and batteries would only last 3 years. What we did not realize is that we had two life expectancies. The battery that would run the gasoline part of the car would last three years, but no one seemed to know the life expectancy of the batteries that would run the electric component (the "hybrid batteries").

We purchased our vehicle in Keene, New Hampshire. After three years, the car stopped working. We had the Prius towed many miles to Keene, unaware that it would have been a simple replacement made at home by swapping the "gasoline battery". In hindsight, we owned the Prius for more than 10 years and the hybrid batteries never needed to be replaced. The hybrid batteries also saved our car.

My wife drove many miles to Keene, New Hampshire for our regular service, which included an oil change. After some time in the waiting room, she was informed that she could drive the refreshed Prius home. When she encountered a roundabout about four miles

away, the oil light came on. She was towed back to the dealership and was informed that they forgot to replace the oil.

As I look back at the Trust Company of Vermont, I don't see gasoline batteries. I see hybrid batteries based on the ages and time working at the Trust Company. Our hybrid is 22 years out. Should we replace some of the batteries? I leave that up to the "hybrid batteries". Fortunately, we have added new "hybrid batteries" (our expanded staff) to stay up-to-date with the growth of the company.

As I reflect on my career choices, I chose trust administration and not investment management. Trust administrators focus on the past, such as existing trust and tax laws. Investment managers tend to focus on the future. I may have recently strayed from administration to investment management.

I personally added to my investment portfolio. I bought an electric vehicle. I still need two cars.

So my "hybrid' is two cars: a gasoline car and an electric car. Perhaps in three years, I might only need an electric car if I retire and my wife and l effectively collaborate the when and where of who needs the car. It is also my hope that an inexpensive electric car will go a thousand miles on one charge (my current one is 258 miles) and convince my wife that the large screen, which she does not like, is the way of the future...and not a distraction once I train her to use the screen when I drive the car.

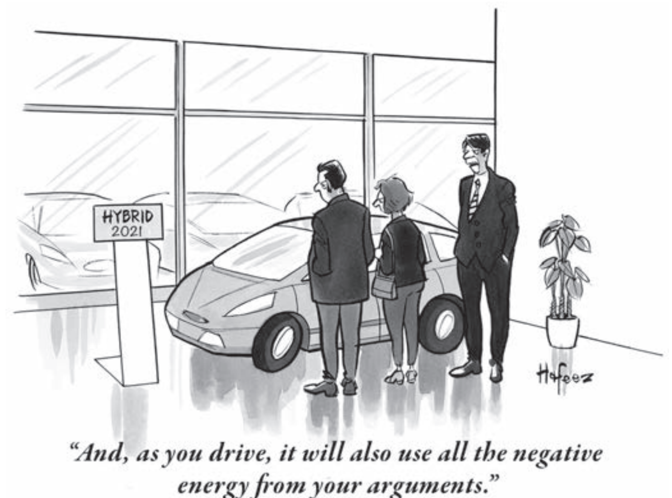
I have spent many months studying the issue. I have watched many videos. Consumer Reports promotes the three-year lease option. I often listen to Consumer Reports, so I chose the lease to allow me to buy the car now and have three more years to study this issue.

Government rebates may, or may not, be available. This is very complicated, much like the proposed changes in the tax laws which have estate planners scrambling to finish a tax saving plan this year. Manufacturers that sell too many electric cars may deprive the buyer of a very attractive rebate.

Luck and happenstance may be a factor. I had Green Mountain Power install a level 2 charger. I chose a location in the back of my garage. Shortly after the electrician finished the project, I went to my iPad to check the news. It felt like I was hit by a bolt of lightning. General Motors had just announced that they were halting production of the Chevy Bolt EV after a number of battery fires. Fortunately the charging cable was long enough to allow me to charge my car outside of my garage. Now my only problem, once I installed the required wi-fi extender, is whether I understood the instruction manual, clearly written for those who possess a "hybrid battery" brain. Hopefully my "battery" was up to the task.

Buying an electric car is complicated. Managing portfolios mindful of global warming and transitioning from fossil fuels may be far more challenging for our investment managers and our estate planners, both now, and in the future.

"If GM had kept up with technology like the computer industry has, we would all be driving $25 cars that got 1,000 MPG" - Bill Gates



"And, as you drive, it will also use all the negative energy from your arguments."

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