Trust Company *of* Vermont Quarterly Update

April 2014

Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

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

What I Learned from the Financial Crisis

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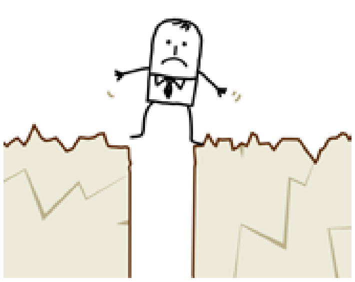
March 9, 2014 marked the 5th anniversary of the bear market lows set during the financial crisis that began in 2007. On that date in 2009 the S&P 500 stock index hit 676.53, over 56% lower than its peak set just a year and five months earlier. For many, that period of time is just a distant memory. This is probably because the market has rallied significantly during the past 5 years and has set new all-time highs. But investors have much to gain from the lessons that were learned during the financial crisis. Even at new highs, the markets face many challenges. If one needs examples, just look at the first 3 months of this year. Volatility remains one of the greatest risks for long-term investors. Therefore, investors who apply these 5 basic tenets may be better able to reach their financial goals.

KNOW YOUR RISK TOLERANCE.



I mean REALLY know your risk tolerance! It is very easy for us to tolerate risk when the market is going up. Unfortunately, investors who overestimate their tolerance for risk could easily have panicked during the bear market and allowed their emotions to make their investment decisions. When this happens, investors will undoubtedly sell at the wrong time and erase any chance they have of participating in a market recovery. We went through the worst economic crisis that this country had faced in 80 years, and it took just 4 years for stocks to return to their pre-bear market levels.

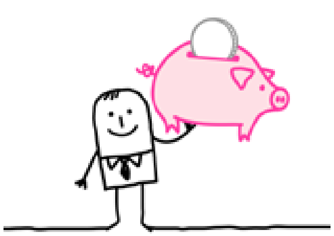
STICK TO THE PLAN.

It is important for every investor to have a well thought-out investment plan. This plan will result in the establishment of an investment objective and an asset allocation policy. An investment objective is a statement of your specific needs and goals and is based on your age, income, planned activities, and, as we mentioned above, your attitude about risk. It is the investment objective that should drive your investments, not the other way around. As an example, if you are risk-averse or know that you will need money in the next year for college expenses, you probably shouldn't be invested 100% in stocks even though the market may be going up. Conversely, if you are 30 years old and saving for retirement, you shouldn't avoid investing in stocks because the market has been going down. Sticking to a long-term plan can help investors avoid short-term decisions that they may regret later.

DEBT IS DANGEROUS!

The three decades leading up to 2008 saw the entire U.S. go on a debt binge, including households, companies and the government. By the summer of 2008 U.S. households owed 10 times as much as they had in 1980. Wall Street believed that household borrowing was O.K. as it allowed people to use their future income today to purchase better homes and buy more things. Unfortunately, many individuals with elevated debt burdens found that they were unable to make payments during the financial crisis, especially when home prices declined. This is not to say that debt should never be used. Borrowing prudently can be an important part of a sound financial plan.

BUILD AN EMERGENCY FUND.

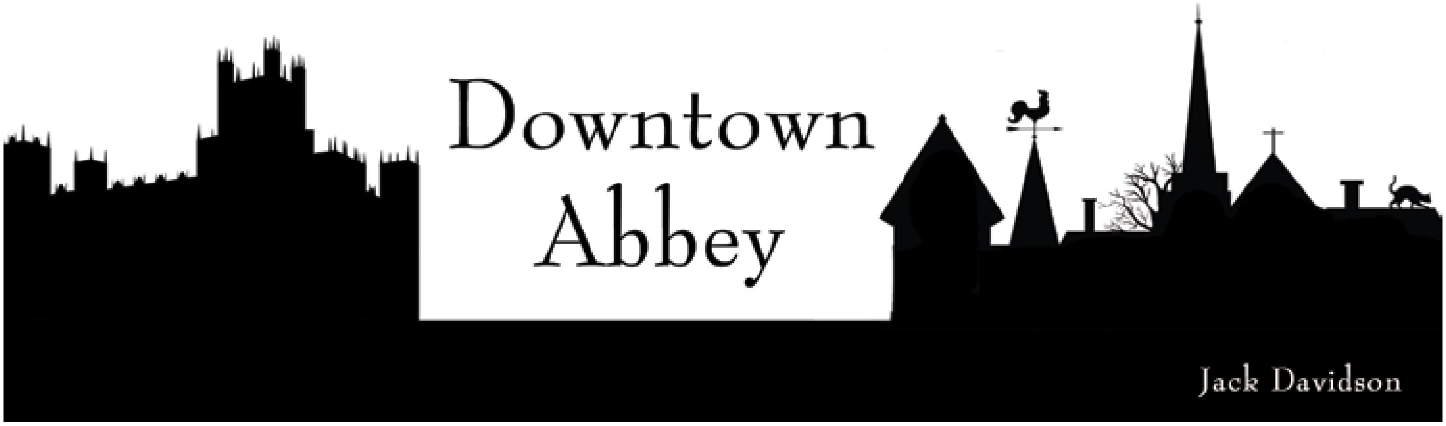


Having cash reserves allows you to meet immediate liquidity needs without disturbing your long-term investments at an inopportune time. Younger investors should keep somewhere between six to twelve months' worth of expenses in some kind of money market fund. Those that are near or in retirement will want to plan for a more prolonged time period, probably one to three years. This can be hard to do with rates near 0%, but having to sell investments at the wrong time could result in heavy losses.

KEEP IT SIMPLE!

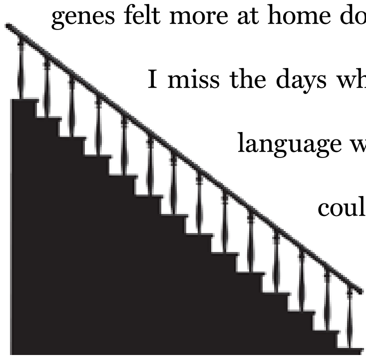
Prior to 2008 hardly anyone had ever heard of something called a credit default swap. But as soon as this financial instrument brought down AIG, one of the most successful insurance companies at the time, many quickly became familiar with the term. To be honest, I have only a vague understanding of what a credit default swap is as these and other complex derivatives are thought of by finance PhDs. It was also during the financial crisis that the downside of investing in a hedge fund came to the forefront as a lack of liquidity caused these funds to plummet in value. The simple, plain vanilla-type investments did just fine. In fact, had you purchased Coca-Cola the day before Lehman Brothers collapsed, your stock holding would now be up more than 60%. Other "old-line" companies like McDonald's and Johnson & Johnson were up more than 80% and 50% respectively. It's an argument for investing in simple assets with simple strategies. It's also a good argument for investing in things you understand and to bypass those you don't.

Five years after the financial crisis, the world looks a little different. New risks and challenges await all of us in the investing world. The good news is that many people are responding by taking control of their financial lives and vowing to not let history repeat itself. If you have questions or concerns regarding your own risk tolerance, how to assess it, or your investment objectives, please do not hesitate to contact any of us at Trust Company of Vermont and we will be happy to assist you.



As part of an employee-owned trust company, I often consult with my colleagues before we commit to helping promote non-profits. Sometimes it can be challenging. One time I succeeded in spite of a misspelling: “If we give to X we will get a plague”. Recently, I wanted to promote a premiere of Downton Abbey for the benefit of a non-profit, and started both mispronouncing and misspelling “Downton”. Some even questioned why I was promoting Downton Abbey knowing that I avoided it like the plague. Why did I hide out in the basement when my wife invited the neighbors over to watch the season’s premiere of Downton Abbey?

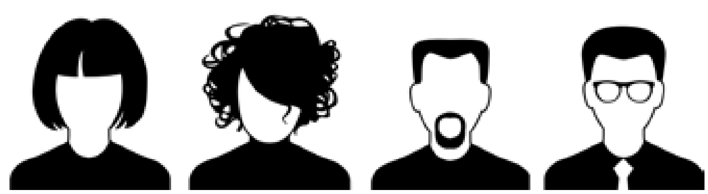
The PBS series, set in the fictional Yorkshire estate of Downton Abbey, depicts the lives of the aristocratic Crawley family and their servants in the post-Edwardian era reminiscent of “Upstairs, Downstairs”. Perhaps my ancestral genes felt more at home downstairs, but I am not sure. I miss the days when we wore suits, when our language was more complex. When we could sit at a long table engaged in stimulating conversation, without our ipads.



I prevailed, but at a cost. I had to go to the premiere. I was impressed. Downton Abbey is populated by a cast of extraordinary characters. Nobility resides both upstairs and downstairs. Scoundrels reside upstairs and downstairs as well. Many are complex characters that manifest subtle changes over time.

Estate Planning is complex. It’s that simple. Our role at the Trust Company is to help our clients understand their existing plans and/or encourage a revisit with their attorney as laws, asset needs or relationships change. It’s an imperfect role. If we are not asked to review a plan, it would be impolite to intrude....as they might say it in Downton Abbey.

In estate planning, the cast of characters often present



challenges in designing an effective plan. It is critical to know the cast of characters, and there may be a few waiting in the wings that may create wonderful opportunities, or havoc, or a script for a screen play. If a non-profit is a beneficiary of a plan, a new cast of characters awaits.

We are exposed to non-profits on a regular basis. Like many of the characters in Downton Abbey, we assume noble behavior and we experience it on a regular basis. Sometimes though, the cast of characters behave differently than what we would expect.

My first exposure to the negative impact of a non-profit was the subject of a lecture years ago. The speaker told the story of a trustee, who in an effort to please both the wife and the child of the deceased donor, changed the portfolio so that the only investments were in safe bonds. The trust provided income for life to the wife, then to the son, and upon his death the property would pass to his children. In the event the son did not have children, the default provision would be a charity. The son, in an effort to increase his mother's income, convinced the trustee to only invest in bonds. Unlike today, bond yields were high. The unmarried son died just before his mother. The charity sued the trustee claiming that the assets should have included stocks, and the damages amounted to 3 million. It was a lecture. It did not feel real. Reality, on the other hand, started to unfold.

A modest man, living in a small town in Vermont, left approximately 8 million in a trust with a local institution to benefit three charities in perpetuity, two local and one with a national presence, a university. The university hired a detective to find evidence that would break the trust so they could add their share to their endowment managed by a boutique firm designed for educational institutions. One of their directors, who headed the Finance Committee, was a principal in this firm. The donor did not want his share commingled with their endowment. Fortunately, the University was not able to break the trust.

In 2007, the New York Times published an article titled "In Big Banks' Hands, Trusts Often Give Fewer Grants"[1] which describes "orphan" trusts and the impact on local charities. An orphan trust is a trust that is left in the hands of friends, local banks or local lawyers and when the individuals can no longer act or the local bank is bought out, the trust beneficiaries become "orphans". The impact when the trust has been taken over by a multinational financial institution is the focus of the article. ***"With no family members to encourage gifts to the original donor's favorite causes, the banks and lawyers have wide latitude to remake the way the trusts operate and to decide which charities will receive grants. Banks can reduce gifts and grow the foundation's assets, thus increasing their fees. At the same time, banks and lawyers stand to gain personal influence and prestige by selecting new charities."***

Does this happen in Vermont? A Donor from Springfield,

[1] *By Stephanie Strom: September 29, 2007*

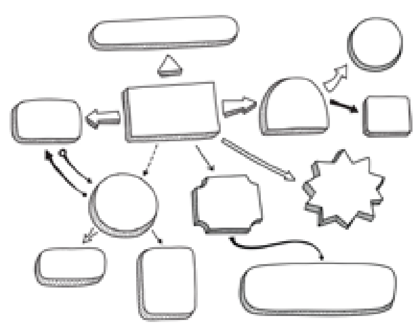
Vermont created a trust to benefit her religious affiliation. She selected a small bank and a local trustee. The local church was a principal beneficiary. The bank, through consolidations, became JP Morgan Chase. When the individual trustee died, the local contributions diminished dramatically in favor of churches based in New York City. Fortunately, the problem with this orphan trust was resolved, but only after litigation.

A patient at a small hospital in Vermont was so impressed with her care that she created a trust to provide "the net income to be distributed at least annually" to meet the medical needs of this Vermont community and its surrounding towns, with primary consideration to be given to the hospital. The initial value was approximately 30 million and the donor appointed a Boston-based bank as her trustee. Upon her death, the Bank engaged a Boston based medical foundation. Subsequently, the Bank defined the territory to include another hospital, and restricted all distributions to specific programs and equipment. The Bank created guidelines that precluded general support and did not appear to address the long-term financial needs of the hospital. Two years after the trust was fully funded, the Hospital's elder care program was closed because of lack of financial support. The important question is: "What did the donor intend?"

Many non-profits survive by the skills of in-house development officers or outside fund consultants. Many of them have been trained to focus on the 10% rule (10% of the prospects provide 90% of the support). The field continues to expand, fueled by the prospect of the imminent transfer of immense wealth just over the horizon. Will it expand? Will we be able to find a version of Warren Buffett or Bill Gates in our community? I hope so, but there may be a problem. The numbers of donors may be shrinking as wealth grows. The richest 85 people on the globe control as much wealth as the poorest half of the global population.

It has been a hard job for many local development officers. The competition continues to grow and often from outside the community. Recently, one noteworthy tax law change reduced the incentive to make a charitable contribution. Now spousal estates under $10,680,000 may not be subject to estate taxes in states that do not have estate or inheritance taxes.

One benefit of the change in estate taxation is the reduction of complexity. Many documents designed to save taxes are simply incomprehensible. Without this distraction, we are better able to focus on the cast of characters: children, spouses, and friends.



Designing plans for people you know may be a challenge.

Add to that list people you don't know, and the plan becomes more complex. If the cast of characters includes non-profits, the growing competitive environment may warrant a carefully designed plan addressing our client's values in the worst case scenarios.

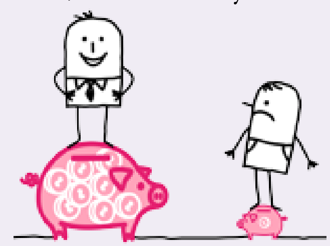
In Vermont, the new notification rules should be considered if a non-profit is involved. Some donors simply do not want the charity to know about the trust administration favoring family members until the family members have no further interests. Documents can be designed or amended to preclude the duty to send reports to the charity.

There are so many non-profits that we admire and support, and many skilled development officers as well. They know their benefactors and their institutions, and they too want to make sure their clients achieve their objectives. A well designed document is our mutual goal and it may not be as challenging as one might think. Just addressing the issues of the charity staying local, defining the type of support, and the impact of family members acting as trustees or beneficiaries with a non-profit waiting in the wings, will take you down the right road, whether uptown or downtown.

I continue to mispronounce Downton Abbey. It always comes out Downtown Abbey. Try as I might. Perhaps my selection of Downtown is a guilt driven subconscious revelation. The term "downtown" is thought to have originated in New York City in the early 1800's. The original settlement was located at the southern tip of Manhattan and growth could only go north. Thus downtown symbolized the commercial district of a city. Most banks and trust companies reside downtown literally and figuratively. We may consciously or subconsciously influence the language of a document. Mea culpa.

The Challenge of the Rich Man, Poor Man Trust

Rich Man, Poor Man was a 1976 American television miniseries based on a novel written by Irwin Shaw. The principal characters are impoverished German immigrant brothers. Rudy was the rich man of the title; well-educated and ambitious, he triumphed over his background and constructed a corporate and political empire. The poor man was his brother Tom, a rebel, who eventually turned to boxing to support himself. Well, it looks like Rudy was the beneficiary of the recent tax law changes but poor Tom may be paying the bill.



Many trusts are created primarily to save estate taxes for people like Rudy and recent estate tax law changes clearly benefited Rudy. But many trusts are also created to take care of people like Tom. The Toms of this world just saw an increase in their tax rates in 2013. Two taxes actually. First the 3.8% Medicare tax that applies to net investment income. Then, the American Taxpayer Relief Act increased the top income tax rate to 39.6% and the top capital gains rate to 20%.

Rudy's tax bracket, assuming a joint return, will kick in at $400,000. Tom's trust will reach this bracket at $11,950. Wow.

As trustee for Tom, how could we have minimized the tax in 2013? Let's assume that the trust earns $73,000 in interest. If the income is not paid to Tom, the combination of Federal and Vermont tax could be as high as $35,824 including a $6,282 Vermont tax (if the source is 100% qualifying dividends, the tax would be $22,219).

Let's assume Tom is married and has no other source of income. Assuming that his wife is over 65 as well, if we paid the interest of $73,000 to Tom, his combined tax would be $8,499.

What happens if Tom is still a rebel and the Trust Company has the discretion to withhold income? If we withhold all the income, we will lose an opportunity to save $27,325. Arguably, the example above was designed to make a point. In real life the savings will probably be less. That said, we face real life stories, perhaps less dramatic, on a regular basis. It was easier to watch them on TV.