

The Benefits of Risk Management

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One of my responsibilities at the Trust Company of Vermont is that of risk manager. I sort of fell into this role accidentally. I sometimes blame it on the bell.

When I first joined Vermont National Bank in November of 1970, I focused on doing tax returns and hardly noticed the stock market. Then in January of 1973 the Dow exceeded the 1000 mark, a pleasant milestone, before it began a very unpleasant decline to 577 by December of 1974. This was a 45% drop. Applying this same percentage to the Dow of 13,910, achieved in October of last year, the Dow would have to drop to approximately 7,700 within the next year to duplicate the experience.

During this period I not only witnessed how dangerous the stock market could be for the short term investor, I also observed how the damage could have been compounded by an overreaction. If one came out of the market in December of 1974 they would have missed a rapid correction as the Dow rose by 48% in a five month period, to close at 855 in May of 1975.

Now about the bell. Just before the Dow peaked, we installed a device that was one step removed from the old ticker tape. We then fed in our buy list and whenever the price of one of our picks declined by 5%, a bell would go off, and a tape would spew forth alerting us to the drop in value. Unfortunately, for the next two years the bell rang far too often. I would guess that many of the those managing portfolios today have only

an academic appreciation of the secular bear market of the 70's. Mine, on the other hand, was felt. It wasn't pleasant and it was continually reinforced by the bell. Now I focus on risk, lest it tolls for me.

Are assets safe in the trust department of a bank or a trust company such as the Trust Company of Vermont?

The good news is that trust assets managed by a bank or trust company, such as the Trust Company of Vermont, or a regulated corporate fiduciary such as a Merrill Lynch, don't go on the company's balance sheet. So, if the company is acquired, as in the case of Merrill Lynch, or files for bankruptcy protection, as in the case of Lehman Brothers Holdings Inc., the trust assets managed by the company are not in danger. If a bank or trust company were ever to fail, your assets are not owned by them and the regulatory authorities would, if needed, supervise the transfer of your assets to a new corporate fiduciary.

So yes, generally speaking your assets are safe even if the institution housing them is not. Having said this, corporate fiduciaries are not immune from backroom shenanigans, so it is important to look at the regulatory body that supervises them. In Vermont, banks are regulated either by the State, or federal agencies such as the Office of the Comptroller of Currency. The Trust Company of Vermont is regulated by the State of Vermont.



Now that we have determined that you or the successor trustee can gain possession of your assets without claims by the creditors of the corporate trustee, the next issue is how safe are your investments? Bear in mind that there is no FDIC insurance available for an asset that has declined in value in your portfolio or trust.

What does the institution do to control risk? What does the Trust Company of Vermont do to control risk? Principally, we do two things: we diversify and we keep the fixed income portion of the portfolio invested in the safest of securities.

Diversification

Warren Buffett's classic quote is very timely right now: "It's only when the tide goes out that you learn who's been swimming naked." In a nutshell, you can simply



limit your exposure to the unexpected, hidden risks, and creative accounting that even the most seasoned analyst may miss,

simply by having meaningful diversification. This means that you do not have an over-concentration in one security and that you focus on asset allocation and asset class diversification. This is our principal strategy and ongoing objective.

In this regard, one of our strengths also gives rise to a challenge: our managers tend to have close relationships with our clients. This may mean that over time they will either subconsciously adopt the sentiments of the client that are harmful to diversification or be less willing to badger them to approve changes that run contra to those sentiments. The two most significant "sentiments" that are obstacles to diversification are over-weighting the tax impact of sales, and "legacy stock". In most cases holding on to an over-concentration of a security because of capital gains is a bad investment decision. And this is more true today than in the past due to the low capital gain

rate. Many of us feel that this low rate will increase soon so, unless the client is quite elderly or the tax accountant advises otherwise, investment decisions should be made on the merits of holding the security rather than the tax consequences of selling it.

Legacy stock is another obstacle. Many of our clients have emotional attachments to securities that have stood them well for many years or were inherited from a parent. In many instances the company today is not the same company that Dad purchased, when the leadership thought long-term rather than quarter to quarter. Our managers know this. They also know that one of their jobs is to try to remove emotional attachments to achieve successful results. It's not easy. Your visit to a trust officer is not supposed to feel like a visit to the dentist.

Fixed Income Strategy

Hesitate to say this, but "in the old days" the fixed income portion of a portfolio was the safety anchor that allowed the manager to focus on the riskier stock portion. The money market funds, and the bonds, were to provide a decent income return without the risk of a decline in value of the underlying security. This is not the case today. We now live in a world of multi-layered complexities inhabited by Collateralized Debt Obligations, bundling, tranches and toxic sub-prime mortgages.

Our approach for the fixed income portfolio is, when in doubt, always take the more conservative route. The safest investment in the fixed income portion of a portfolio should be the money market funds. I can remember the day in 1974 when John Abel came into the office and said that we should consider these new money market funds, instead of the lower paying savings accounts we were using at the local banks.

What made these new money market funds so special other than ready access to a pool of short term fixed income investments? Answer: you could put a dollar in and get a dollar out regardless of the value of the fund. Well how could that be? Answer: the Security and Exchange Commission allows this if the assets are high quality, the fund is diversified, and the maturities are very short. Well what happens if one of the borrowers

defaults? Answer: you might get a little less than a dollar back. What happens if all the securities are guaranteed but everyone redeems at once? Answer: well, the fund manager will have to sell securities before their maturity dates and you might get a little less than a dollar back.



Getting “a little less than a dollar back” means the fund “broke the buck”.

This has rarely happened. Until Reserve Primary Fund broke the buck last month, having lost \$785 million as a result of its Lehman holdings, only three money funds had broken the buck in the 37 year history of money funds.

So there are two types of risk when you invest in money market funds: the risk of default and the risk of a run on the fund. In order to address the risk of default, the Trust Company of Vermont began the process last October of switching from a Goldman fund of corporate securities to a Goldman fund of U.S. Agencies.

Do we worry about a run on the government fund? No. The underlying assets are safe so, in a worse case scenario, we only expect an insignificant variance between the stable market value and the real market value. It is interesting to note that in the case of Reserve Primary, where there was an actual default, 60% of the

investors got out with 100% of their investments and the last redemptions came out between 95% and 97% of their original investment.

Regarding tax exempt money market funds, like all our existing money market funds, they are now protected by the U.S. Treasury Department’s Exchange Stabilization Fund. The protection only applies to the lower of the account’s current balance or the balance as of the close of business on September 19th. It is for this reason that for the immediate future we plan on sweeping all future cash receipts to Federated Securities U.S. Treasury Fund in all our accounts holding tax exempt money market funds, to isolate the protected funds.

Unlike money market funds we only need one paragraph to describe our bond philosophy. We tend to favor government bonds over the higher yielding corporate bonds. If we feel a bond fund is appropriate, we only use conservative well managed bond funds. This has given us considerable comfort of late.

In conclusion, our philosophy has always been to achieve good performance without taking undue risk. It is why you will probably not see a dramatic change in our investment approach as we attempt to wait and sort out what is occurring in the market. We have never forgotten the bell.

Tax Analysis of Long Term Capital Gains

Let’s take the example of Client A who holds stock currently worth \$100 per share with a tax cost of \$5 a share and Client B who holds the same security with a cost basis of \$50 per share.

Here’s the initial impact on sale for a Vermont taxpayer compared to the equivalent drop in the S&P:

	Cost Basis	Market Value	Gain	Tax	Proceeds	Drop in S & P
Client A	\$ 5	\$100	\$95	\$19	\$81	19%
Client B	\$50	\$100	\$50	\$10	\$90	10%

From this chart, it appears that Client A would be better off holding the security if it doesn’t drop below 19%. Unfortunately it’s not that simple. Client A is still holding a security subject to tax. If, for example, the stock only drops 10% and Client A does not sell, then Client A is still holding a security with a tax cost basis of \$5 and a market value of \$90 and unpaid taxes of \$17. Compare this to selling at \$100, paying the tax, and now holding cash of \$81.

What if Client A is 84 and there is the possibility that capital gains will disappear upon death? The life expectancy at 84 is 5.84 years. As David points out in the following article, the S&P has dropped 27% since last October.

In doing this tax analysis I have not taken into account certain minor adjustments such as the deduction for state taxes nor the unlikely but possible impact of the alternate minimum tax.