



# Trust Company of Vermont Quarterly Update

October 2018

Brattleboro ♦ Burlington ♦ Rutland ♦ Manchester ♦ St. Albans

Employee-owned & Vermont-based

[www.tcvermont.com](http://www.tcvermont.com)

## NOTHING COSTS A NICKEL ANYMORE

BEN FERRIS, PORTFOLIO MANAGER



THE 1960S WAS A TERRIFIC DECADE FOR AMERICA. Neil Armstrong & Buzz Aldrin were moon walking, Beatlemania was sweeping the nation, and 2001: A Space Odyssey hit the theaters for the first time



in 1968. That same year, the average price of a movie ticket was \$1.31. Parents handing out money to their

children were probably shocked at the monumental price tag. Who can blame them? Movie tickets 50 years before that were about \$0.07.

In the last half century, the value of the dollar has declined a whopping 86%, or at an annual rate of about 4%. This annual “tax” on our spending power is commonly known as inflation. It is generally known that bondholders are directly subject to the inflation tax as the real value of their dollar deteriorates in an inflationary environment, given the nature of a bond’s



fixed income and principal payments. Unadventurous knowledge presumes that stocks are different than bonds. The thought goes that stocks don’t lay claim to fixed payments, like bonds, but instead represent an ownership stake in an enterprise with real assets, and those assets should retain their real value over time. A closer look at the data tells a different story.

In 1977, Warren Buffett wrote a brilliant article entitled “*How Inflation Swindles the Equity Investor*” that I will attempt to summarize in the following three paragraphs.

According to data compiled by the NYU Stern School of Business, publicly traded U.S. companies have averaged an annual return on equity of roughly 12% over the last two decades. Longer term data also puts this figure at about 12%. Let’s think of these companies not as publicly traded stocks, but instead as privately-owned businesses. Let’s also assume that the owners acquired the assets of these businesses at book value, meaning they bought the business for what it cost to purchase the productive assets employed, such as factories and

inventory. Since the longer-term data suggest that the return on equity is about 12%, the owners of these businesses would receive \$12 of annual earnings for every \$100 they invested in the business.

**This 12% return on equity can be thought of like a fixed bond coupon received every year, regardless of what inflation has been or will be.**

There are many factors that can influence return on equity in any given year, but if we assume the 12% “equity coupon” is here to stay, future investing results are primarily driven by a few factors, the most significant being: inflation, the Taxman (unfortunately for investors, the one by the Beatles is far more cheerful), and the relationship between market and book value. A thorough discussion about market and book value is beyond the scope of this writing, but the concept of Buffett’s 12% equity coupon is important and should be well understood by owners of stock (If I did a poor job explaining, please feel free to call me).

Just as bondholders face the inflation tax, so do stockholders. In times of high inflation, owners of all assets are worse off because the return from the assets you owned is lower in a real sense. And that’s why nothing costs a nickel anymore. This inflation tax is pervasive and often goes unnoticed, especially when compared to Uncle Sam’s doings. If \$100 is invested in a bond yielding 5%, and the \$5 of income is taxed at 20%, the after-tax return for the investor is 4%. However, if inflation is 4%, as it has averaged over the last half century, the real return after the inflation tax is 0%. This would be the equivalent to an income tax of 100% in periods of 0% inflation. I’d imagine far more outcries against the latter example. So, are we all as doomed by inflation as Dr. Poole was

by HAL 9000? Fear not! We simply must find and own companies (at reasonable prices) that have terrific economic characteristics and are able to increase prices in periods of inflation. An example should illustrate the point.

Let’s imagine we own shares of a wonderful bakery that produces the best cookies in Vermont and our



brand is widely known and admired. Let’s call this company Delightful Treats. Delightful Treats competes against a poorly run bakery across town named Yummy Uncooked Cookie

Kompany (YUCK). Both companies earn \$20 million in annual operating profit after taxes, but Delightful only had to invest \$100 million in tangible assets such as ovens, cooking ware, and inventory. YUCK, on the other hand, had to invest \$200 million in tangible assets just to earn the same amount of operating profit. The key distinction is that Delightful has far more economic goodwill than YUCK because our company has a fabulous brand and an untarnished reputation. Delightful earns 20% on invested capital while our competitor earns just 10%. Let’s also assume that both companies are constantly valued by the market at 10 times after-tax operating profit, or \$200 million, initially.



Now, consider the effect that 10% inflation would have on these two businesses. Both companies would now need to earn \$22 million in after-tax operating profit to keep up with inflation. This would simply require increasing prices by 10% for the same number of goods sold. To bring about this increased level of profitability, both companies would have to invest 10% more tangible capital in the business because prices for

machine parts, inventories, and receivables would also increase by 10%. YUCK would need to deploy an additional \$20m of incremental capital (10% of \$200 million) to increase after-tax operating profit by \$2 million and would then generate \$22 million of after-tax operating earnings, and the market would value the company at \$220 million (10x \$22 million). This means that it took YUCK \$20 million of capital to create \$20 million of market value, a mediocre result. On the other hand, Delightful Treats would only have to invest an additional \$10 million of capital (10% of \$100 million) to increase after-tax operating profits by \$2 million, and the market value of the company would also increase from \$200 million to \$220 million. Thus, Delightful was able to invest just \$10 million of capital to create \$20 million of market value.

**This is why companies that have intangible assets such as brands are so valuable in an inflationary world.**



While no one can escape the inflation taxman, we can mitigate, and sometimes more than offset the tax, by searching for companies with wonderful economic characteristics and purchasing them at an equally wonderful price.

## Welcoming Ben Ferris



We're happy to share the news that Ben Ferris has joined us as a Portfolio Manager out of the Burlington Office. Ben comes to

TCV with a B.S. in Quantitative Economics from Tufts University and work experience at Putnam Investments as an equity and fixed income research analyst. A native of Essex Junction, Ben was also a standout high school basketball player and later captain of the Tufts University Basketball team. Ben divides his time between Providence, R.I. and Essex Junction, VT.

## Paper Statements Piling Up?



As of January 2019, our clients can opt to discontinue paper statements in favor of electronic copies, or "E-statements". This option includes those clients who already access online statements but still receive an annual hard copy statement. You can now opt for no paper copies at all.

E-statements offer the benefits of:

- Quicker access to your account information
- More eco-friendly
- Less clutter
- Eliminates the security issues of mailed statements

Your E-statements are accessed via a secure website and available for up to 18 months for you to view or download. If this appeals to you, please let your administrator know. Signing up requires one-time paperwork that we will be happy to handle for you.

# HILDEBRANDT'S

Jack Davidson - Employee-Owner of Retirement Age

Growing up on Long Island in the 50's, my parents would take their five children to Hildebrandt's to buy ice cream.



Not often, but enough to cement a relationship that would never leave...I was introduced to the best ice cream on the planet. Recently, a colleague suggested a movie with the storyline set and filmed in 2017. So I decided to watch the trailer as a prerequisite to perhaps entertainment. Then my world started spinning...the trailer included Hildebrandt's. Nothing had changed. How could this be?

Thanks to the internet, both a curse and a blessing, I immediately travelled to East Williston, New York, on my computer and once again fell in love with Hildebrandt's. Nothing had changed, except the ownership, which was committed to staying the same....and I encountered a revelation. Hildebrandt's had discovered how to stay in a business that started in the late 1920s and now, 90 years later, the business model has not changed. They discovered "The more some things change, the more they stay the same".

Here are extracts from their web page:

*"A little about what you can expect if you're visiting us for the first time: Fresh food, made to order, with as much personal service as we can muster on any particular day. We're not fine dining. But we are really good dining. And we have to hope that most of the people who find us for the first time will be looking for just that. And be happy they found us."*

*"We've recently had a huge, bright, public light trained on our little, family business. And while it's exciting and we're confident that we will navigate the attention with as much grace as possible, we've been thinking a bit about the other side of the coin. Hmmmm. Not every person who walks in the door is going to fall in love. (Ooooo, yeah, well, we knew that, I guess). We're going to get some bad reviews, most likely, not just lukewarm. (Who said that? What's his damage?) Some people will judge us by standards that don't really apply to a 14 table ice cream parlor/ luncheonette /confectionery. (It was too noisy? Really?) And, some people just won't like us."*



*"While most of this will be wonderful and fun, (for all of us, we hope), we imagine there will be some stumbles. Regardless, as usual, we promise to do our best and we truly hope you like what we have to offer."*



The Trust Company of Vermont is about to turn 20 years old, but our business model was one that the founders embraced when they started working in Vermont in the early 70's. A very simple model not unlike Hildebrandt's: simply maintain long term relationships, not unlike maintaining the best ice cream on the planet. *"The more things change, the more they stay the same."*



We are in transition. We are older and we encourage older members to work part time, rather than retire, and we want to maintain this business model in perpetuity.

Currently, approximately 15% of the staff is age 70 or older and the rate will increase significantly in the next few years. After age 62, employees may start the process of reducing their workload. Approximately one-third of our staff now work part-time.

So, we may have some stumbles that we need to address. One by-product of our model is the concept of working on-site forty hours a week.



In family-owned businesses, often the owners may work many more than 40 hours a week. But the employees may still encounter and embrace

the 40 hour week. It is an old-fashioned model that employees should work on-site and be visible. All of the founders had been employees and then overnight, when the founders formed the trust company, we became the owners. We now need to abandon both the forty-hour rule and the rule that the boss must work from dawn to dusk.

**ANGELA BOWMAN - EMPLOYEE-OWNER**

**MANY YEARS FROM RETIREMENT:**

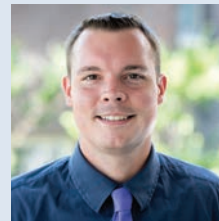


*"Working hard and putting in the effort is as important as the time we spend at our desks. If we can get our work done in 20 hours, we should*

*be asking "What more can I do?" "What else can I learn?" If we are working 60-70 hours a week, we should be looking to find ways to reduce work load so we do not get burned out. This could be by finding efficiencies in how we work or hiring additional staff"*

**CHRIS CASSIDY - EMPLOYEE OWNER**

**MANY YEARS FROM RETIREMENT:**



*"Nationwide, people are working later into their lives. For example, in the 1980s about 25% of men age 65-69 were working. Today that*

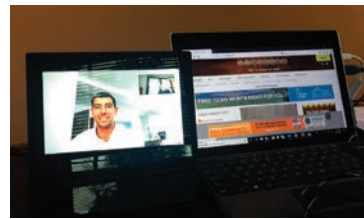
*number is almost 40%. These trends are partially due to the fact that people, on average, are living longer. The average female life expectancy in the 1980s was 78 years. Today the average female life expectancy is 81 years of age. At Trust Company of Vermont, some of our most knowledgeable employees are 70+ years of age. They enjoy their work, but also want to spend more time with their families and check items off of their bucket list. We have found it a beneficial arrangement to both our company and our clients to keep these highly knowledgeable individuals employed on a part-time basis."*

JACK DAVIDSON - EMPLOYEE-OWNER  
OF RETIREMENT AGE:

ANGELA: *“The system we have built allows for tiered retirement and for those that have built the company to stay on as long as they’d like. It may be in a different or reduced role, but in the end, it is their dedication, knowledge and relationships that I count on. It isn’t how many accounts they still manage or bring in, it goes back to the core of TCV which is building trust and bringing a steadfast dedication to those we work for, both clients and employees within.”*

CHRIS: *“A challenge for all companies is hiring and retaining talented employees. As Trust Company of Vermont hires new employees to make up the next generation of employee-owners, we need to be cognizant of millennial values and preferences. Millennials are now 30% of the nation’s workforce and flexibility is an important part of their criteria when choosing employment. According to recent studies, one third of millennials have quit a job due to lack of flexibility. Nationwide, more employees are working remotely (not just millennials). According to Gallup, 43% of all surveyed employees work remotely at least some of the time. We recently hired former Trust Company of Vermont Intern, and Essex Junction native, Ben Ferris. Ben appreciates the ability to work remotely some, if not most of the time, and we value his skill and experience in investment analysis.”*

I have been a proponent of working off-site for many years and I have embraced technology as a critical component of a company dominated by healthy business owners who are able to balance a family life and an effective work environment. But don’t be fooled by the technology that now exists here and



elsewhere. The goal is not the iPads and iPhones and the large screens and internet-based phone systems.

My personal goal is to be part of the creation of a company where each succeeding generation has the same experience. When you go into Hildebrandt’s you will see iPads and iPhones, but it is the best ice cream that unites us all. Sorry, Ben and Jerry.

I have also been a proponent that no one should retire unless they want to retire. Now that I am in the retirement years, I have to endure levels of age discrimination. I can still put in window air conditioners without the help of others. That said, I can lose names and keys and phones, but to those who consciously or subconsciously aid this type of discrimination, I simply say “I AM GOOD ENOUGH!”

In 1980, at age 57, Dr. John Goodenough co-invented



the lithium-ion battery. In 2017, at the age 94, he has co-invented a low-cost all solid-state battery that may revolutionize the industry. Goodenough credited

old age with bringing him a new kind of intellectual freedom. At 94, he said, “You no longer worry about keeping your job.” As an employee-owned company, we don’t fear losing our jobs or .....so we hope.