



# Quarterly Update April 2010

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## Happy Anniversary Bull Market

*David DeBellis, Trust Investment Committee*



March 9, 2010 marked the one-year anniversary of the end of the last bear market. After 16 months of market decline and financial crisis causing investors fear and trepidation throughout 2008 and early 2009, the Standard & Poor's 500 Stock Index bottomed at 676 on March 9, 2009; down 57% from its all-time high of 1,565 reached in October 2007.

Since then, the calls for a second Great Depression have receded, much of the world economy has started to grow again and investor sentiment has gone from apocalyptic to hopeful. Stock markets around the world have staged powerful rallies. As of March 31, 2010, the S&P 500 is up 73% from its March 2009 low, marking the strongest advance for any first year of a new bull market since the

1930's, according to Standard & Poor's. Similarly, the MSCI EAFE and Emerging Markets indexes were up 78% and 104% respectively for the same time period based on representative ETFs.

Hindsight tells us that March 9, 2009 was one of the greatest opportunities to invest in most of our lifetimes, but the situation wasn't nearly as clear back then. The bear case was that the economy and corporate profits would be in a slump for a long time. Really, other than attractive valuations on stocks, there was little to get most investors excited about committing cash to the equity markets.

Today, stocks are no longer the bargains they were back in early 2009 when the P/E for the S&P 500 was just above 10 times the then 2010 earnings estimate of \$66 versus a P/E of 15 times the current 2010 earnings estimate of \$78 on March 31, 2010. And there is plenty of reason for concern; including a fragile domestic recovery, European debt problems, overly in-

debted U.S. households, and high unemployment. But the fact is, there are always reasons not to buy stocks. In the long term, staying invested has always been the right move.



Uncertainty is a key word as newscasters struggle to explain each day's volatility. "The market does not like uncertainty." After nearly 20 years of investing, I can assure you that the future is never certain. In the 1970's the concern was inflation; in the 1980's the money supply and Latin American debt; the 1990's brought a real estate crash and the savings and loan debacle. Of course the 2000's had more than its share with the technology bust, and the current real estate and mortgage bust.

# Poof Planning

If you are waiting for certainty, your rate of return will most likely be equal to that of a 30-day Treasury bill, which these days has a yield of around 0.16%. It is risk investment that generates excess returns. Yet risk must be assumed in a thoughtful manner and your risk should be mitigated where possible. Don't take on risk if you can't afford to do so. If you will need the money in the next one to three years, then you are taking too much risk investing in stocks.

So what are some of the important lessons that investors should take away from the last 13 months? One thing is that it is so important to stay invested. Trying to time the market is a loser's game. Had an investor sold on March 9, 2009 the only thing he would have succeeded in doing is locking in his losses. Depending on if or when he re-entered the stock market he missed part of the rally. Within one week of the low, the market was up 11.5% and in two weeks the market had rallied 22%.

Another lesson is to develop a diversified investment strategy and rebalance the portfolio on a consistent basis. Do not become consumed with where the best returns are, but instead focus on a fair return for the risk you are willing to assume and how best to position yourself to achieve it. By doing this, you will usually outperform any decision based on emotions.



2010: The one year repeal of the Federal Estate and Generation Skipping Tax and the one year reinstatement of the ill fated '76 carryover basis rules.

It's magic: Now you see an unlimited Federal exemption. Now you don't. Now you see possible carryover basis and large capital gains on assets sold after death. Now you don't. Now you see relief from the Generation Skipping Transfer Tax. Now you don't. Poof! Now you see it. Now you don't.

If they pass a law to reinstate the Federal Estate Tax, they may make it retroactive to January 1, 2010. They may do the same with the Generation Skipping Tax. If they don't, then on January 1, 2011 both taxes will be reinstated and the exemption will drop to 1 million for both, with a maximum rate of 55% unless Congress settles on a higher exemption, which most planners expect will happen before year-end. But then again we were wrong in 2009 when many of us expected a permanent exemption between \$3.5 and \$5 million.

We've never had to deal with Poof Planning before. What do you do? If you are a Vermont resident, married, and you possess a combined net estate in excess of two million, then you might want to check with your lawyer if you have not already done so. Some of the techniques now being used to save Vermont estate taxes, such as Disclaimer Trusts and Single Fund

QTIP trusts, function extraordinarily well during poof periods. But they may not be appropriate for some married couples.

Another good reason to check in with your lawyer is that the widely used formula clauses may, in some instances, now unintentionally alter the share passing to or for the benefit of the surviving spouse. This is of particular concern in plans designed for second marriages.

You may also want to give your executor the ability to allocate cost basis to probate and non-probate assets without fear of liability. The income tax basis of inherited property is no longer "stepped up" to the property's date of death value. Instead, new "carry over" basis rules mean that appreciated property acquired from a decedent will continue to have the decedent's adjusted basis. The law permits an executor to allocate up to \$1.3 million to increase the basis of any estate assets, and an additional \$3 million to increase the basis of assets passing outright or in trust to a surviving spouse.

Although we still have a gift tax and exemption of one million, the maximum rate drops to 35%. In addition, Vermont does not impose a gift tax. Perhaps gifts should be considered during 2010 while the rate stays low. Better yet, gifts to grandchildren will now be free from Generation Skipping Tax, unless, poof, a change is made retroactive.



# Looking Ahead: The Predictive Science

Jack Davidson

When we put our last quarterly newsletter to bed, I decided to write a brief section on Estate Planning. I did not plan on discussing the implications for our clients *if* the Federal Estate tax law did not change before year-end. I simply assumed that the Congress would not allow for the complete repeal of this tax. I was wrong. We now have no federal estate tax, a new capital gains rule for assets passing upon death, and the potential for a significant increase in the Federal Estate tax in the year 2011.

I failed to predict this turn of events. I usually don't need to spend time predicting what will happen in the future. Estate Planning tends to move at a pace somewhere between a snail and a tortoise.

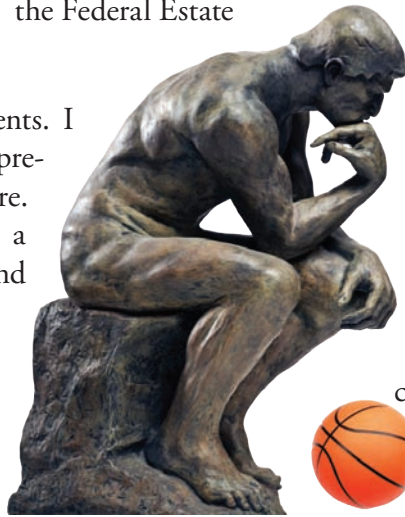
Looking ahead is the job of our investment managers. They need to be very good at balancing the need to predict which investments will do well moving forward while employing a risk avoidance strategy to counter the possible impact of the unpredictable. That is what many of our clients pay us to do on the premise that a managed portfolio will outperform a non-managed one over the long term.

Perhaps some of our readers are familiar with the *efficient-market hypothesis*. According to this theory, it is not possible to consistently achieve returns in excess of average market returns, on a risk-adjusted basis. Many adherents of this theory will suggest that an unmanaged, well-diversified fund will perform as well as, if not better, than a managed fund.

Our investment managers favor the selection of individual stocks and bonds rather than funds. Invariably, our portfolios are not so widely diversified as to test the efficient market hypothesis. We are prudently diversified and that will result in better long term performance if we make intelligent, informed choices. Thus, it should come as no surprise that all our managers believe that over the long term randomness will result in less than ideal performance. So you won't find

any managers throwing darts at the Wall Street Journal stock tables. When it comes to predicting the future, they are very consistent in their approach.

Or are they? March has been truly mad here at the Trust Company of Vermont. Some managers are throwing darts, metaphorically speaking; not at the Wall Street Journal but at the New York Times Bracket Challenge. This all started last year when one of our investment managers, Chris Cassidy, introduced a company-wide pool and most of us were persuaded to join in predicting who would win in each round of the NCAA Basketball Tournament. Mr. Cassidy is a basketball expert. He studies the game, the teams and the players. He also plays the game and is the JV coach for Rice High School (17 wins and 3 losses) and, as the Head Coach for 17 year olds, won the 2009 Vermont State AAU championship.



Yours truly was persuaded by Chris to enter the bracket challenge last year on the assurance that lack of knowledge would not be a detriment. He suggested that the randomness could be a strength. Alas, I followed his advice, finished last, and picked up the nickname "Caboose".

This year I decided to study the entire process on the theory that if I could identify parallels in the selection process to those employed by our managers in the selection of assets, I could shed both the random approach and my nickname.

So I interviewed a few participants. For contrast I included our administrators as well.

Starting with last year's winner, **Andrea Freeman**: "I used the expertise of my twelve year old son Tanner. He's the family expert." In a family of basketball aficionados, that says a lot.

Just a few points shy of first place was **Chris Cassidy**. Chris spends countless hours studying both stocks and basketball. When asked about the latter he responded: "It's pretty much my life outside of here." (Note to file: make sure Chris gets out more.)

**Peter Sherlock:** “There is too much randomness to have a reasonable prospect of success and there is not enough at stake to let me pick a team I do not want to cheer for even though I think they will probably win.” Pete brings a whole new dimension to value investing.

**David DeBellis:** “I like to study other people’s analysis of potential outcomes. I use the same approach I use in investing assets.”

**Bobbi Flynn:** “I thought the higher seeds were the better team.” We thank Bobbi for allowing us to test the contrarian investment approach, inadvertent as it might have been.

**John Abel** eschewing fancy algorithms: “Nothing special. I just chose the better-ranked teams.”

**Ashley Ferrone** on the merits of phonic investing: “I sounded out the names to Ella (her two year old daughter) and chose the ones she could repeat.”

**Jane Waysville:** Jane made the mistake of kidding Chris after his choice, Kansas, lost. He immediately coined her first ever nickname “Trash Talking Jane”. Although Jane’s vocabulary remains respectful and respectable, she no longer gives interviews.

**George von Trapp,** who was willing to play to show group solidarity even though he doesn’t like the game: “As a relatively short person, I was never any good at the game. My wife played in high school and can beat me consistently when we play H-O-R-S-E.” George’s methodology for selection was quite complex and I can only conclude that CPAs inherently know the threat of March Madness to an April 15 deadline.

After many interviews, I developed a rating chart whereby I assessed the personal expertise of the participant, including members of their household who might be available to them, and I examined their methodology. Then I assigned a level from 1 to 10, with 1 being the most random and ten being the highest level of expertise and methodology. Then I compared

this rating to the actual performance. Here are the results:

Rank	Name	Score	Level
1	David DeBellis	464	8
2	Jane Waysville	410	8
3	Chris Cassidy	396	10
4	Jack Davidson	396	1
5	John Abel	375	7
6	Ellen Lowery	373	7
7	Angie Freeman	351	8
8	George von Trapp	351	3
9	Ashley Ferrone	350	1
10	Steve Singiser	334	5
11	Deb Brown	332	4
12	Lori Miller	319	5
13	Kathy Patenaude	312	2
14	Pat von Trapp	307	8
15	Harold Hebert	286	4
16	Mike Rafferty	276	4
17	Peter Sherlock	267	5
18	Rich Pearce	257	5
19	Bonnie McLellan	250	5
20	Greg McConahey	232	1
21	Bobbi Flynn	144	1

After seeing the results, I felt comforted knowing that the person who used the same methodology for basketball as he does for investment management finished in first place as well as the evident correlation between expertise and success. That said, my third place finish in a tie with Chris, our company expert, may at first appear as an anomaly. My understanding of basketball is certainly very low. However, this year I hired the 12 year old Tanner Freeman, who advised



his mother Andrea last year, Tanner Freeman to make all my picks. So perhaps the moral of this story is that if you do not have the expertise, hire someone who does.