



Trust Company of Vermont Quarterly Update

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“The Winner’s Game”

David DeBellis, CFA & Portfolio Manager

Most people have a summer reading list that consists of a good mystery, a steamy romance novel or a book about someone who was, is, or wants to be the

President of the United States. Not me; summer is my time to catch up on reading research and articles about my profession. One periodical that I receive is the Financial Analysts Journal, issued by the CFA Institute.

I confess that much of the time I never get past the index of articles. This is probably due to the fact that many of the articles have titles like “Pricing Credit Default Swaps with [yawn] Option-Implied Volatility”.

But this summer’s issue had an article that caught my eye. The title of the article was “The Winner’s Game” and it was written by Charles D. Ellis, CFA. The article is about the investment management business in general. It describes three systemic errors that cause investors to make mistakes and the changes that we can make to help ensure that investing becomes “a winner’s game” for our clients and ourselves. The first two are errors of commission and the third is an error of omission.

The first error is one that all investment professionals struggle with. That is that we have falsely de-

fining our professional mission to our current and prospective clients as “beating the market.” Reflecting on my own experience, I joined the Trust Company shortly after its creation. I was attracted to being part of a group that was trying to create a company that managed assets for the long term, where the company’s objective was one of alignment to the objective of the client. They refused to sell investment products where they might be tempted by the commissions or to utilize a “manager of managers” program where the focus was trying to outperform the market. They even stopped bidding on the management of institutional funds where changing board members would change the focus to their definition of “beating the market”.

The sentiment of the group was that in order to achieve our clients’ objectives we should not focus on beating the market. They felt that inherent in beating the market is a short term strategy that may ultimately imperil the long term goals of their clients.

When we visualize “beating the market” we see a foot race and the measurement period as laps. If our goal is to create a healthy portfolio ten years from now, we may fail to accomplish it if we win most of the laps but collapse before the end. Recently the Manager of Legg Mason Value Fund announced that he is retiring after being at the helm of the fund since its inception in 1982. Bill Miller is famous for having one of the

most amazing performance streaks in mutual fund history. He managed to outperform the S&P 500 for 15 straight years. From 1991 to 2005 he managed an average annual return that was 5 percentage points higher than the market. Seeing this amazing feat, individuals flocked to the fund hoping to see that kind of return on their money as well. Unfortunately, the five years following that amazing streak were not as kind to Mr. Miller or his investors. He underperformed the S&P 500 by over nine percentage points and lost over seven percent of the value of the fund on average in each of those five years.

In his article, Ellis points out that fifty years ago investment professionals could take up the mission of beating the market with a reasonable prospect for success. But today it is nearly impossible due to the massive changes that have transformed the markets and investment management so greatly. Some of these changes include:



- New York Stock Exchange (NYSE) trading volume is up over 2000 times – from about 2 million shares a day to about 4 billion.
- The 50 most active institutions do 50 percent of all NYSE listed stock trading and the smallest of these spends \$100 million annually in fees and commissions. Naturally these institutions get the “first call.”
- Advances in technology have revolutionized global communications to a point where we really are “in this together.” The increasing usage of social media in business, such as Twitter, means that everyone knows what is going on the minute it happens.

As a result of these and many other changes, the stock markets have become increasingly efficient.

The second error that Ellis points out is that some investment professionals have allowed the values of the profession to become dominated by the economics of their business. As investment management organizations get larger, business managers have displaced investment professionals in senior leadership positions. This, in turn, has led to actions aiming to increase an organization’s results as a business, such as cost controls, fee increases, and drives for greater “productivity.” These actions increase the chances that the organization’s professional results will suffer.

Ellis comments that the third error is particularly troubling for all of us who want our work to be recognized as a valuable professional service. In making the first two errors, the best service that can be provided to clients is missed and shifted away from effective investment counseling.

While all investors are the same in several ways, they differ in many more ways: assets, income, spending obligations and expectations, investment time horizon, investment knowledge, risk and uncertainty tolerance, market experience and financial responsibilities. With all of these differences, investors need help in designing investment programs that are really suited to themselves. Ellis uses skiing as an analogy. With trails of varying difficulty, from the bunny slopes to triple black diamonds, skiers of different abilities can all spend an enjoyable and fulfilling day at their local ski resort.

He contends that both clients and investment professionals would benefit if we spent less time trying to beat the market and more time helping clients understand the realities of the market and clarify their realistic objectives. By improving the fit of the investment service to each client, we increase the duration of the relationship and thereby the economic value of the client-manager relationship; a classic win-win situation for all.

2012 ECONOMIC & MARKET OUTLOOK

MORE OF THE SAME - LIVING IN THE “NEW NORMAL”

TODD GRAY, PORTFOLIO MANAGER

For those of you who do not like to watch reruns of television programs you may want to change the channel when it comes to viewing the U.S. economy in 2012. Similar to this past year, economic growth in 2012 will be below the 3% historical average and will likely represent only a small increase over that of 2011. With unemployment levels remaining stubbornly high, personal income growth will remain moderate and consumer spending will remain well below pre-recession levels. Since consumer spending accounts for approximately 70% of U.S. GDP and with government spending being reduced at the State and City level, it is difficult to make a case that economic growth in 2012 will turn out to be substantially higher than that of 2011.

Despite a substantial increase in consumer spending during the fourth quarter of 2011, consumers currently face too many negatives to produce a robust spending recovery in the upcoming year. Much of the recent rise in consumer spending was financed either by dipping into savings or by taking on additional debt, not a strong foundation for a spending recovery in 2012. While this recent spending spree does show that the U.S. consumer has considerable pent up desire to spend, a weak labor market, high debt burdens, house prices that have not yet hit bottom, price increases that have outpaced wage growth, and a lack of confidence in the government's ability to get its fiscal house in order will restrain consumers' spending plans.

Bill Gross of PIMCO fame coined the phrase “New Normal” to describe his outlook for an extended period of below normal levels of economic growth resulting from the effects of deleveraging by a debt laden consumer and ultimately by governments with substantial budget deficits. This period of transition away from debt driven economic growth would result in market returns that were considerably below historical averages while at the same time producing high levels of volatility. This is certainly what stock investors experienced in 2011. Despite a number of sharp movements both up and down, the S&P 500 stock index ended the year at basically the same point it began. Looking forward, a combination of election year politics, a dysfunctional Congress, continued concern over the financial crisis in Europe, slower economic growth in China and global political hot spots such as Iran will likely result in significant market volatility in 2012. Mr. Gross states that during this period annual investment returns of greater than 5% will be difficult to achieve and will likely be the figure by which superior returns will be defined.

With interest rates at historically low levels, the potential return for bonds is quite low and runs the risk of being negative if there is any material upward movement in rates due to global sovereign debt concerns. With the dividend yield for the S&P 500 Index currently above the yield on the 10-year U.S. Treasury bond, I recommend investing in stocks with dividend yields superior to that of the index, particularly



focusing on companies with a track record of growing their dividend each and every year. In this “new normal” era where stock returns are more moderate, dividends will account for a significant portion of stock returns. An additional benefit to owning stocks with superior dividend yields is that they historically have been less volatile than stocks that do not pay a dividend. During periods of high volatility, dividend stocks have historically outperformed growth stocks, as they did in 2011. Thus, in addition to offering better yields than government bonds, dividend stocks offer the opportunity for annual income growth as well as long-term price appreciation.

There is no better way for someone in the investment business to appear the fool than to participate in foretelling the future. While I would prefer to be ever the optimist, experience has proven that in making market prognostications it is far better to suffer the ridicule of the investment community, or clients, by being too cautious than suffer wrath for being incorrectly optimistic. There are basically two types of losses in the investment world; one being the loss of an investment opportunity, and the second being the loss of investment capital. The good news regarding losing out on an investment opportunity is that history has shown there will be additional investment opportunities to take advantage of in the future. However, the loss of investment capital makes future opportunities irrelevant. Therefore, we at TCV prefer to manage money with a healthy amount of caution preferring to occasionally miss opportunities in order to protect our client’s investment capital during times of significant uncertainty and volatility. The good news is that we believe that the U.S. economy will continue to expand, although at a slow pace, and that the risk of falling back into recession in 2012 has diminished since the mid-point of last year. We also believe that at current valuation levels stocks offer attractive returns over the next five to ten years so there is reason to be cautiously optimistic.

We at TCV wish all of you a new year full of joy, good health and prosperity.



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IRA Contribution Limits for 2012

Traditional and Roth contribution limits for 2012 are unchanged from 2011: \$5,000 for individuals under 50 and \$6,000 for age 50 and over. The maximum SEP contribution for 2012 has increased to \$50,000, up from \$49,000.

Simple IRA limits are unchanged: maximum \$11,500 for those under 50 and \$14,000 for age 50 and over.

401k deferrals: Maximum contribution is \$17,000 for those under 50 and \$22,500 for age 50 and over. These are slight increases from 2011 limits.

If you have any questions, please contact your administrator.