



Quarterly Update January 2006

Brattleboro ♦ Burlington ♦ Rutland ♦ St. Albans ♦ Stowe

286 College Street.....Our New Home in Burlington

It is hard to believe we have recently passed our sixth year anniversary. As many of our readers know, the company was founded by 8 former employees of the Vermont National Bank Trust Department. What many people don't know is that we, the founders, used our 401-K money to provide most of the capital to open three offices on September 16, 1999.

Our main office is located in an historic building that was constructed in 1868 as the Vermont Savings Bank. Almost 100 years later, Vermont Savings Bank merged with the Vermont Peoples National Bank. After the merger, Vermont Peoples National Bank sold the building to our current landlord, and not long thereafter changed its name back to its founding name in 1814, the Vermont National Bank. We consider this location our permanent home and are very thankful that our landlord feels the same way.

When we started the company, frugality was not a debatable issue. Now it has emerged as one of our core values. We still vacuum the floors, work without secretaries, buy used furniture and otherwise avoid waste. This tendency pre-dates the formation of our company so it doesn't seem to be a by-product of our employee ownership.

We also believe in spending when it makes us more efficient, increases the quality of our services, or is consistent with our long term objectives. Thus, if you compare us with other bank trust departments, our fees tend to be less and our staff levels are higher. We can do this for two reasons; we avoid waste and we don't have the burden of paying ever increasing returns to our equity investors.

Our key objective is permanence. This is our raison d'être. We are long term investors for families that want us to manage money for more than one generation.



If all goes as planned, by the time you receive this newsletter, we will have closed on the purchase of a Burlington Victorian built in 1892 by Lawrence Bartley. Lawrence was evidently a sea captain who plied his trade on Lake Champlain and this probably accounts for the widows' walk. The building will be our permanent home in Burlington and is located on College Street, next door to the Ethan Allen Club.

So we think 30 years out. Thus it is natural for us to be drawn to historic buildings, preferably downtown. Buildings with history not only symbolize permanence, they remind us of a time when community institutions stayed in the neighborhood. They remind us of a time that a local bank could stay independent from 1814 to 1999. So bricks and mortar are important to us so long as they are prudently purchased in locations that will serve as permanent homes.

In this context, we are pleased to announce that we have found our permanent home in Burlington.

A Happy & Healthy New Year

Financial Markets The 2006 Outlook

David DeBellis, CFA, Portfolio Manager



At this time of year I am often asked how I think the markets will perform during the next twelve months. After thinking about this question for a while, I have come to the conclusion the market will probably produce moderate gains not unlike the ones we've seen for the last two years. The S&P 500 rose 9% in 2004, and through the end of November, the market was up almost 5% on a total return basis (dividends plus appreciation).

Real GDP growth will slow next year. The Federal Reserve is going to make sure of this. In 2004, Real GDP grew by 4.4% and will probably come near 3.6% this year. If the Fed is successful in manufacturing a "soft-landing," we will hopefully see Real GDP growth slow to its sustainable rate of 3%. And as you might expect, along with a slowing in the economy, earnings growth will also slow next year. Operating earnings grew by more than 20% in both 2004 and 2005, and I don't think corporate America can continue at this pace. Corporations are also coming under margin pressure as costs rise and the ability to pass those increased costs diminishes due to global competition. Lower margins and tough historical comparisons mean growth in operating earnings will probably slide to a more sustainable rate of 7%. The earnings slowdown limits the upside potential for the stock market next year.

If earnings grow 7% as we expect, the market will be up only that amount, unless P/E multiples (the price investors are willing to pay for a dollar of earnings) increase. And this will only happen if the market expects interest rates to drop or earnings growth to accelerate at some point during the year. It is possible that if the Fed stops raising interest rates in early 2006 that the earnings outlook could improve, leading to higher earnings growth.

The biggest risk to the market as I see it is a spike in interest rates and inflation. The Fed is almost certain to raise rates in January 2006. If the Fed raises the fed funds rate beyond 4.5% the market could experience further compression in P/E multiples. This scenario

seems less likely now, considering the Fed's comments following their interest rate hike in December. They stated that they no longer felt that monetary policy remained "accommodative," perhaps suggesting that the Fed is near the end of this tightening cycle. If inflation rates inch higher, the Fed might be willing to slow real GDP growth below 3% in order to control inflationary pressures. That could lead to even lower operating earnings growth. If either the P/E multiple or earnings growth rate decline, the stock market upside will be limited.



A big positive for the stock market is the extraordinarily healthy nature of corporate balance sheets. The strong growth in earnings the past two and one-half years has allowed companies to reduce debt and increase cash balances. Companies are rapidly raising dividends and increasing stock buyback programs. These trends are clearly good for the stock market, and are now occurring in tandem with strong corporate investment trends, as evidenced by the nearly 10% increase in the business component of GDP over the last two years.

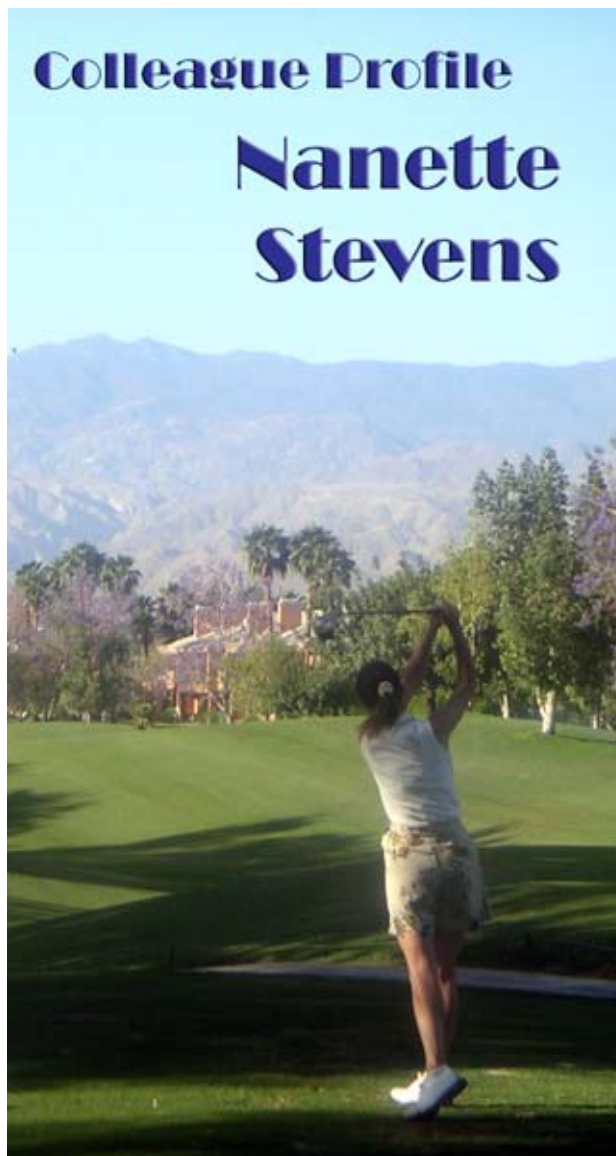
At present, the potential rewards in the stock market are not overwhelming. Economic and earnings growth are almost certain to slow from the strong pace of 2005. Interest rates are likely to rise further across the board. Inflation will probably pick up a bit. All of these factors limit the upside potential of the stock market. And in this kind of environment large company stocks with good value may offer a safe haven with decent returns relative to the overall market.

The balance of risks and reward for 2006 leaves my assessment at "cautiously optimistic," a phrase that we at Trust Company of Vermont have used quite frequently over the last several years. The economy should grow by around 3 percent next year, earnings growth should be 7%, and interest rates are almost certain to rise. None of this is particularly exciting, but with P/E levels having already dropped and with strong balance sheets, that leaves room for another year of modest gains in stocks for 2006.

Nanette Stevens was addressing a group of bankers taking a course on trust services. She had recently left a brokerage firm to join the Trust Department of Vermont National Bank as an investment manager. When asked why she left, she replied “I was encouraged to sell the riskiest investment products because they generated the highest commissions. One morning I felt I couldn’t look at myself in the mirror and I decided to leave.” The year was 1989. Ten years later, almost to the day, she co-founded the Trust Company of Vermont.

Nanette’s a skilled investment manager, but when asked what she likes about working in trust her response is “ I am very organized, and I like to get things done. I get a good feeling when I can use these skills to help people”.

In our company, the investment managers are not isolated from the client. Although they all have much in common, we are unable to suppress their individuality. Recognizing this, we try to match our client’s needs and personality to the manager that is the best match. Nanette’s a natural project manager and she’s a perfectionist. What we have discovered is that these particular skills are very much in demand. Clients not only want us to pay attention to their portfolios, they want us to help in collateral family matters from riding herd on the attorney to finish the will, to taking care of a relative with special needs.



Colleague Profile

Nanette Stevens

*“She’s half my size
and out-drives me?”*

- Anonymous 230 lb male golfer

So we would like to profile a colleague who has these special skills. However, we have one problem. Our profilee is reserved. You wouldn’t notice this if you met her. You certainly wouldn’t see it on the golf course when she collected her winnings on the 18th tee. But this profile will be uncomfortable for her. So we will try to avoid our usual interview process designed

to disclose something we didn’t know about the person. Nor will we attempt a Jungian analysis of her all time favorite “The Phantom of the Opera”.

Nanette spent her first eleven years in Whitestone, New York. That’s Queens County, Long Island, which is a far cry from Bennington, Vermont, where the family moved their business so that their four children would have a better place to grow up. Nanette had spent summers in Wilmington, so the move wasn’t as jarring as one would expect. Nonetheless, as an eleven year old living next to the Mount Anthony golf course she encountered a few challenges. Oddly enough, one of those was a pressure to play golf, and she wasn’t fond of the sport.

Nanette graduated from the University of Vermont in 1983 with a major in Business Administration. She then began her career as a trust investment officer at the Chittenden Bank.

In 1987 she joined a local brokerage firm and shortly thereafter discovered that investment management, rather than security sales, matched her talents and her values. So she returned to the world of trust investing where she has remained ever since.

Not long after joining the Chittenden, her destiny started to unfold in the

rough between the second and eleventh holes at the Burlington Country Club. That's where she met Bob Stevens, grew to love the sport of golf, and, one might say, started her second career as mother of the three daughters that followed.



Jacqueline, Jennifer and Nina are all athletes, and Nanette is their project manager. Their many activities provide endless opportunities for her to exercise her organizational talents.

Maintaining two careers is difficult in the best of times and we salute Nanette, and the other mothers in our company, for being there for their clients and their families.



**As of the new year,
the Estate
Tax Exemption
is now 2 Million.**

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Limbo, *Where Art Thou?*

The Vatican is thinking of doing away with the concept of Limbo as a spiritual place awaiting some of the multitude. We hope that Congress will consider following suit for those with estates above \$1,000,000 who are contemplating the impact of their passage to the hereafter. Although the current Federal Estate Tax exemption is now \$2,000,000, and due to increase in increments to infinity in the year 2010, it returns to its less lofty level of \$1,000,000 in 2011 if there is no agreement on high. Recent efforts to repeal the Estate Tax were derailed by an Act of God, Katrina. Consequently, we are still in limbo inasmuch as supporters and opponents of repeal seem to agree that an exemption of an amount above 1 million is desirable.

Married couples using Bypass Trusts can effectively double their exemption. That is to say, if the exemption is 1 million, they can avoid estate taxes on a combined estate of 2 million. If Congress settles on a 2 million exemption, then estates under 4 million can pass tax-free. What do you do? If you are married and your combined estate is \$2,000,000, do you forego the Bypass Trust on the theory that you will not have taxes to pay, or do you create it anyway?

There are a lot of good non-tax reasons for a Bypass Trust. The spouse and perhaps the children are provided for, and the assets are protected from creditors, subsequent spouses, and spendthrift behavior. Nonetheless, even if you use your surviving spouse and/or children as trustee, you have probably saddled one or more family members with the need for specialists. And specialists cost money. We like to think that knowledgeable and efficient specialists such as the Trust Company of Vermont tend to bring more value than cost, however red tape of any sort may not be something that you want.

In this period of limbo, you may want to consider a special type of Bypass Trust, a Disclaimer Bypass Trust. This type of trust typically allows the surviving spouse to make the determination of how much, if any, of the family assets will go in trust. The "disclaimer" needs to be made within 9 months of death and is subject to one or more pitfalls, so contact your estate planner or give us a call to learn more.

Also, you may want to consider that there is another type of limbo. It's the dance limbo with the calypso music in the background, whereby the bar gets lower and lower. So we may descend to one million, or perhaps, lower. A Disclaimer Bypass Trust may allow you to go on a Caribbean cruise worry free.