



# Quarterly Update January 2007

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## Financial Markets Review & 2007 Outlook

For those invested in the stock market, 2006 turned out to be a pleasant surprise as the S&P 500 posted a total return of approximately 15.8%. This was more than twice what most analysts expected when they were projecting 2006 returns.

The primary factor that led to this surprising performance was stronger than expected earnings growth. At the beginning of 2006, it was assumed that the projected weakening of economic growth would lead to a smaller advance in corporate profits. But instead, the 7% increase in fourth quarter earnings growth appears to be closer to 16% as we approach the end of the fourth quarter. This extra 9% gain in earnings almost exactly accounts for the out-performance in the index.



The price/earnings multiple (P/E) stayed very steady. Prices were about 16.3 times earnings a year ago and that number is little changed with fourth quarter earnings estimates. The stable multiple reflects a generally unchanged long-term outlook for interest rates and the economy and clearly shows that the strong gain this year was directly due to the extra, unexpected growth in earnings.

This seems to suggest that, results aside, 2006 was a stable and uneventful year for stock investors. Nothing could be farther from the truth, as the year saw sharp swings in the market. Stocks rose modestly in the 1<sup>st</sup> quarter of 2006 and even through April. But in May, investors became nervous that the Fed, in order to combat inflation, would raise rates too far, missing the anticipated “soft landing” and perhaps even cause a recession. Additionally, an anticipated slowdown in consumer spending related to the housing downturn was compounding this concern.

Then on July 19, Fed Chairman Ben Bernanke testified before Congress making it clear that inflation was not getting out of control and that the Fed would not raise rates much more, if at all. Since then, economic growth slowed to a more sustainable rate and energy prices declined further, fueling a stock market rally that has lasted, almost without interruption, for more than five months. Investor confidence was also boosted by a number of private equity buyouts, corporate mergers and stock buybacks.

### The Outlook

2007 should be another good year for stock investors, just probably not quite as good as 2006. On a

comparable basis, stocks appear to be the cheapest of the major asset classes, especially when compared to bonds and real estate, and therefore should produce the best risk-adjusted returns.

The average S&P 500 stock is trading at approximately 14.8 times 2007 earnings expectations. That translates to an earnings yield of 6.8%, which is very attractive relative to the current 4.5% yield on the 10 year U.S. Treasury note. This is important since, historically, the market tends to do much better when earnings yields are high relative to Treasury notes.

Another historical indicator that is important to remember is that since the Kennedy administration, the third year of a presidential term has produced positive stock returns every time, and with the exception of one case, the returns have been in the double digits.

In our view there are two major risks to the market. As has been the case over the last several years, geopolitical risks and the repercussions from such events will continue to threaten the market. Americans have become somewhat desensitized to such occurrences with each passing year, but there is still the risk that they negatively impact investor confidence.

The second risk that we see is an up-tick in inflation or an unexpected reacceleration of economic growth that would cause the Fed to reverse its position on interest rates. The market has discounted the idea that the Fed would remain neutral for at least the first half of 2007 with the possibility of a rate cut later in the year. A major change from this would be a negative for the stock market.

In keeping with our investment philosophy, we believe that constructing a diversified portfolio of high quality, reasonably valued stocks, is the best way to build and maintain wealth over the long run. We feel confident that the current economic environment is favorable for these large, multi-national corporations as they are well suited for periods of slower growth and can benefit from their exposure to overseas markets.



We're delighted to present the estate planning reflections of noted attorney Christopher Stoneman on

our website. Mr. Stoneman is a Vermont attorney who concentrates his practice on wills, trusts and estates. The holder of law degrees from Cambridge University (1949) and the University of Virginia (1957), he has written and lectured extensively on estate planning and related topics. For the full details of this nineteen article series, visit:

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

## Prognostications.....



Every year it has been the task of our investment managers to predict how the market will do for the ensuing year. Our company is almost evenly divided between the investment staff and the administrators, and, although the administrators have complete confidence in the market prognostication abilities of the managers, they will surrender no other territory. How about other weighty matters? Who are the better seers? The managers or the administrators? So we asked them to predict the future in three important areas, and we will report the outcome in the next newsletter.

### Super Bowl:

- Chargers: 21.43%
- Colts: 7.14%
- Eagles: 7.14%
- Giants: 7.14%
- Patriots: 50.00%
- Ravens: 7.14%

### Best Picture Oscar:

- Bobby: 7.14%
- The Departed: 14.29%
- Flags of Our Fathers: 28.57%
- The Queen: 14.29%
- The Devil Wears Prada: 7.14%
- Dreamgirls: 21.43%
- Little Miss Sunshine: 7.14%

### Punxsutawney Phil Sees His Shadow:

- Phil sees his shadow: 85.71%
- Phil does not see his shadow: 14.29%

## COLLEAGUE PROFILE JACK DAVIDSON



English is Jack's second language. The reason: Jill.

It was a fateful day in 1943 when his father, expecting either a boy or a girl, impulsively and fatefully responded "Jack and Jill" when informed that names were needed for the twins, numbers two and three, of his eventual five offspring.



Twinspeak lasted for some time. Jack and Jill would engage in long conversations, employing a vocabulary unknown to others. When they finally emerged into the world of English-speak, a circular form of communication emerged, reinforced by their mother Loretta.

Loretta Delaney was the last of 8 sisters growing up on a farm in Skaneateles Falls, New York. The Delaney clan was probably much like the other farm families of the time as described by Russell Baker in "Growing Up", "...we lived on coffee and talk. Talking was the great depression pastime. Unlike movies, talk was free, and a great river of talk flowed through the house...". From this storytelling culture Loretta emerged with a profound ability never to let a story get away from her, even though it usually gave birth to many others that emerged so rapidly that they appeared concurrent rather than consecutive.

Into this world, wandered A. Barrett Davidson, an only child with a reserve ill suited for the large, gregarious family gatherings of the Delaney clan and the ever growing extended family. After he and Loretta were married, he did the only sensible thing, he took his bride and fled.

Growing up on Long Island, and fueled by his mother's displacement, Jack grew to believe that heaven resided in small towns abutting family farms. It's one of the



reasons he was drawn to Vermont. After graduating from St. Michael's College in Colchester, he reluctantly returned to the congestion of the metropolitan area to attend Fordham Law School. Nearing graduation, he met his soon-to-be wife, Judy, who was about to attend graduate school at the Fordham School of Social Work. They were married in September 1968.

Jack planned on returning to Vermont. Fortunately, Judy, encouraged by her family who resided in New Hampshire, was eager to make the change as well. However, Jack felt that he needed experience before he could make the move, and after graduation he took a position as a Tax Editor at Prentice Hall.



As a tax editor, his job involved summarizing long tedious tax decisions into one paragraph. It wasn't a good personality match. He felt much more at home taking one paragraph and writing long tedious tax decisions. Nor was the compensation sufficient to start a family. So when Judy informed him that she was pregnant, he turned to his brother-in-law, a rising star at Chase Manhattan Bank, and said, "Help". And that's how he ended up in the Trust Department at Chase.

Less than two years later, while visiting his wife's family, a friend sent an ad for a position in the Trust Department at Vermont National Bank. Although he felt he hadn't yet gained enough experience to be considered for the position, he was unable to mount a strong defense to the urging of his mother-

in-law to take the interview. As fate would have it, his retaliatory “well, if I have to ruin a perfectly good vacation day, I am taking your daughter with me”, was revealed years later as a brilliant strategy when his boss confessed, “ I was hiring Judy Davidson”.



They arrived in Vermont in November of 1970. Jack, Judy, and Jim, and within a year they were joined by Pete. In October of 1975, management promoted him to head the Trust Department. This decision was puzzling to some, who were aware of his emerging quirky eccentricities, but unaware of his hidden strength, which first surfaced in third grade when it was noted on his report card “Jill seems to be doing all his homework”. So over the years, he hired talented people who would do his homework. When Vermont National merged in 1999, he simply turned to a number of these same talented people and said, ...“Help”. They now form the nucleus of the Trust Company of Vermont.

While at Vermont National in mid-career, Jack grew concerned on when he and Jill would go over the hill. That’s when the exercise program began in earnest. It lasted for years, marked by such noteworthy achievements as recording the slowest swim time in the history of the Spofford Lake Triathlon, and having scars named after him on the shins of fellow soccer players. Then just a few years ago, he surrendered to time. He turned to golf, more or less to the exclusion of all other sports, embracing a controversial philosophy. At this very moment he is celebrating vindication and claiming

that he is a golf visionary having just seen the headline of the January issue of Golf magazine: “You Can Buy a Better Game”.

Jack’s role in our company includes risk management and estate planning. His risk management is noteworthy by his obsession that the secular bear market of the 70’s will return. Consequently, our clients can sleep at night knowing that if you are over 25 years old he will be working behind the scenes trying, albeit unsuccessfully, to get 100% of your portfolio into U.S. Government securities.

Regarding estate planning, he has 37 years of experience, which many of our clients find helpful for the range and depth of problems that he has encountered; such as the need for a new Will because “the horse died” (his first plan) to the benefits of an “Intentionally Defective Grantor Trust”. He is at home with the complexities of many estate plans, and is very willing to help educate our clients. And judging by the decline in the number of glazed looks, we think he is only episodically lapsing into twinkspeak.

### Enhanced Security for Internet Access

When you access your account via our website,



[www.tcvermont.com](http://www.tcvermont.com), you will soon notice some changes in the sign-on procedures. We’ll be implementing newly available security enhancements for your

protection. A quick enrollment process will include selecting a validation image and several security questions and answers.

Once the enhanced security is activated, the log-in process will initially request only your User ID. If your User ID is valid, your validation image and a prompt to enter your password will be displayed. If you recognize your validation image, you’ll know for sure that you are at the valid website and it is safe to enter your password.

If you have any questions, please contact your Administrator. If you haven’t signed up for Internet access to your account yet and would like to, please let us know. It’s convenient, secure and available 24 hours a day.