

Investment Commentary

By David Bosworth, Trust Investment Officer

Despite market volatility generated by the credit crunch, housing market collapse and hedge fund debacles, the U.S. stock market as measured by the S&P 500 index gained 2% during the third quarter. Moreover, through September the index is up 9.1% on the year. While the numbers for the overall stock market were quite satisfactory during both periods, there was a wide degree of variation across asset classes (see table).

Each of our tactical asset allocations has added value in 2007, with emerging-market, short-term bonds, commodities and our overweighting to large-cap stocks all outperforming our strategic (neutral) allocations. At the security-selection level, our bond fund managers have also added value, but our equity managers have had mixed relative performance and year-to-date as a group have not added value.

“Prediction is very difficult, especially of the future.”

The above quote is credited to physicist Neils Bohr, and it comes to mind when assessing the developments of the turbulent third quarter and what they may mean for investors.

The Economy—Within the realm of economics and investment, it is easy to find plenty of intelligent sounding predictions about the future. Investors are drawn to forecasts about the economy and the markets because they make investment decisions much easier. Unfortunately, accurately predicting the future is another story. The real key is to accept that some things are inherently uncertain and instead focus on the knowable. The trick is then to balance the two when assessing a range of possible outcomes.

When assessing possible scenarios, it would be immensely helpful to accurately predict the health of the economy. One thing we know is that credit is the lifeblood of the economy and it has become less available than it was. The ability of home buyers to easily access capital, without having to prove their creditworthiness, will go down as one of the defining characteristics of the last few years, as it contributed to an unprecedented surge in housing prices in many parts of the country. At the same time, in the leveraged buyout market, loans were written on remark-

ably generous terms, which spurred acquisitions at ever increasing cash-flow multiples and boosted stock prices.

The bottom line is that the economic outlook is murky. Due to the credit crunch and continued deterioration in the housing market, recession is more likely than it was earlier in the year, but it is not a foregone conclusion. The few firms whose economic forecasting we respect, continue to believe that a recession is not the most likely outcome, but most are less confident than they were a few months ago.

Valuations—When focusing on the knowable, we find comfort in our ability to estimate asset-class valuations. Valuation analysis allows us to gauge how much risk is reflected in the price of an asset class. We believe the key question in investing is always, “What is being discounted in the current price?” Conceptually speaking, when assets are cheap, many of the negative factors are already taken into account in the price. If these negative factors never materialize, prices should rise sharply as investors realize that they were over-discounting the risks. If the risks do pass, the asset price already largely reflects them. When assets are expensive, the reverse is true. While valuations are part math and part art, we have a framework that assists us assessing valuations.

With respect to larger-cap stocks, all of our earnings based valuation work suggests stocks are somewhere between reasonably valued and cheap. However, the analysis is not this simple. The concern is that profit margins have been rising steadily during the past three years and are at unusually high levels, which has led to surprisingly strong earnings growth—way above the long-term earnings growth trend of 6% to 7% annually in nominal terms. In the past, when earnings have jumped ahead of the trend, they have followed with a period of subpar growth.

September Benchmark Returns (Preliminary)		
	Sept	YTD
Large-Cap Benchmarks		
Vanguard 500 Index	3.7%	9.1%
Russell 1000 Growth iShares	4.2%	12.5%
Russell 1000 Value iShares	3.4%	5.9%
Mid-Cap Benchmarks		
Russell Midcap iShares	3.3%	9.3%
Russell Midcap Growth iShares	3.9%	13.2%
Russell Midcap Value iShares	2.5%	4.7%
Small-Cap Benchmarks		
Russell 2000 iShares	1.7%	3.3%
Russell 2000 Growth iShares	2.9%	9.2%
Russell 2000 Value iShares	0.4%	-2.8%
Other Benchmarks		
Vanguard Total Intl Stock Index	6.4%	17.0%
Vanguard REIT Index	4.3%	-4.1%
Vanguard Total Bond Mkt Index	0.7%	3.7%
Merrill Lynch High-Yield Bonds	2.4%	3.4%
Salomon Brothers World Govt. Bond	2.5%	6.8%
DJ-AIGGI (Commodity Futures)	8.0%	11.0%
JPMorgan ELMI +	4.0%	11.1%

Why We Invest in Mutual Funds

By Jim Miller, CFP, President & CEO

What is the most prudent way to invest, given the objectives of our clients and the uncertainties of the investment markets?

Our Investment Process

Our investment process was established to address the question posed above. Figure 1 illustrates the key stages of our investment process.

Based on an understanding of the client's unique situation, their objectives and their feelings toward risk, we establish an appropriate broad investment strategy. Each investment strategy has unique risk and return characteristics that determine how much will be invested among stocks, bonds and money market funds.



figure 1

A key defining characteristic of our process is our focus on tactical asset allocation— looking for opportunities to increase returns or reduce risk by changing the amount invested in the various asset sub-categories and investment styles. A great deal of research and analysis is continually put into these decisions as we monitor the investment markets and our clients' portfolios. Our focus on tactical asset allocation is a key distinction from many other investment approaches.

Investment categories that we actively research and consider for inclusion in our clients' portfolios include:

- Larger-company Stocks
- Smaller-company Stocks
- International Stocks
- Investment-grade Bonds
- Lower-quality Bonds
- International Bonds
- Commodities
- Real Estate Investment Trusts (REITs)

Examples of different investment styles we use include:

- Value
- Growth
- Growth at a Reasonable Price

We make tactical changes to the amount we invest in each

of these categories and styles to take advantage of opportunities. These opportunities are often presented during times of market turbulence, when there is a great deal of fear or pessimism among investors and specific asset classes are driven down to bargain prices. In contrast, opportunities to reduce risk arise when there is unwarranted exuberance among investors and certain asset classes are driven well above what reasonable valuations can justify.

Implementation

Following the decision regarding how much to invest in each investment category, we need to implement the strategy. Investment vehicles available include individual stocks and bonds, mutual funds and separately managed accounts (an approach that hires multiple managers who each purchase individual securities on the clients' behalf). Merchants Trust Company has carefully considered each of these investment vehicles and believes mutual funds are the most prudent vehicles to use for our clients' portfolios. The remainder of this article will discuss why we prefer the use of mutual funds to other available options.

Efficient and Cost-Effective Method of Changing Exposure to Asset Classes

Changes to our client portfolios are most often a result of a change in our outlook for a specific asset class. When we identify an undervalued asset class, we prefer to invest quickly and in a manner that provides us with broad exposure to the asset class. We also wish to avoid any unnecessary expenses. Mutual funds are superior to individual securities as vehicles for making these tactical changes among asset classes. When we buy and sell mutual funds, there are no transaction costs involved. Buying and selling individual stocks involves commissions and there can be significant costs involved when buying and selling individual bonds.

Timeliness, accuracy and cost effectiveness are equally important for rebalancing. Due to the natural fluctuations of the market, portfolios deviate from their target allocations. Mutual funds provide a precise method of bringing the alignment of the several asset classes and styles back in line with their





target allocations.

There are also times when a client's tax situation dictates a change within the portfolio. For example, if a client moves from a high tax bracket to a low tax bracket, it may be advantageous to move from tax-exempt bonds to taxable bonds to generate a higher after-tax yield. This can be done with mutual funds, without any transaction costs. Making this change with individual bonds might result in a cost to the investor of more than 3% of the value of the bonds.

Diversification

Mutual funds provide professionally managed and diversified exposure to multiple asset classes in a manner that is very difficult to achieve with individual securities. Proper diversification is a critical component of managing portfolio risk.

After-Fee Performance

Mutual funds charge a fee for managing fund assets. This fee is an important factor in our fund selection process. We will only hire a manager if we are confident that they will generate a long-term investment return that beats the market benchmark by an amount that exceeds their fee. While the fee is a significant factor, more important is the value we are getting for the fee.

Tax Efficiency

The most tax-efficient method of investing is to purchase individual securities, hold them until death, and then following a step-up in the cost basis to the value on the date of death, heirs can sell the securities with little or no gain. While this is certainly very effective in minimizing taxes, it may not be successful in generating the highest after-tax rate of return. To do so requires the insight and wisdom today to select securities that will be the winners several years or decades into the future.

Any method short of holding until death only defers paying tax. (An exception would be if the value of the security subsequently declines and is sold at a loss—an even more desirable tax result!) Taxes must be paid sooner or later. What is lost is the time value of the money paid in taxes today, which otherwise could have been reinvested. By paying some taxes now, the tax liability when you ultimately sell is reduced. The impact of paying the taxes each year, rather than paying it all when the fund is sold, is actually considerably smaller than most people think. It should also be noted that while deferral of tax is generally favorable, if the capital gain tax rates increase in the future from today's favorable rates, it may be advantageous to realize gains today. (See figure 2)

An alternative to buy and hold is to actively manage a portfolio of individual securities. If the manager recommends a change, the investor can always opt out of the change if they wish to avoid the capital gains that would be realized from the

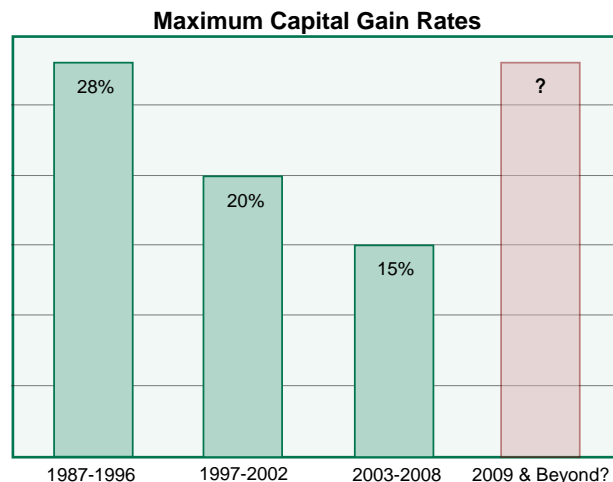


figure 2

sale. But doing so will be contrary to the recommendation of the manager (who was hired because of their expertise). For example, when a manager recommends the sale of a stock, it can be assumed that it is because they believe it is no longer the best investment for the portfolio. They are selling the stock to replace it with an investment that they believe will generate a higher return. They are making the change at the time they believe to be most advantageous. If the investor opts out of or postpones the sale and continues to hold the stock, they will defer capital gain income, but possibly at the cost of a lower investment return (assuming the manager is skilled at managing their portfolio and selected a superior investment).

The use of mutual funds requires delegating control of security selection to the fund managers. The investor has no control of the amount of capital gains that will be realized and passed through by the fund each year. This is far from ideal, however, we believe enabling skilled managers to make timely buy and sell decisions, with an objective of generating the highest investment return, is in the best interest of our clients. While no one enjoys paying taxes, tax avoidance should not dictate investment decision making.

We believe that mutual funds are the investment vehicle that provides us with the best chance for success. This success does not hinge on the success or failure of the mutual fund industry at large, it only requires the ability to find a small number of good funds within this large and highly-imperfect industry. This is what we do, and we can say with confidence that we are able to find enough high-quality fund investments to be successful.

Investment Commentary

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What This All Means—we are constantly making decisions in an uncertain world. Economic predictions are not accurate enough to serve as a basis for investment decisions. We are more confident in our valuation work as a basis for decisions, but this can not be done in a vacuum. So, what do we do?

We know the economy might fall into recession, but it might also avoid recession and surprise on the upside with the aid of Fed easing, a weaker dollar that stimulates exports and global growth driven by emerging markets. Getting defensive may well result in missing out on returns that could be captured during, potentially, a few more years of economic growth. (It is worth noting that many of the 'experts' arguing for a defensive posture now have been bearish on equities for many years and missed the strong global equity market rebound since 2003.) On the other hand, stocks might drop 10% to 20% or more in a cyclical bear market.

What we do first is draw on our basic building blocks of portfolio diversification.

- Investment-grade bonds perform much better than stocks and other equity oriented asset classes in recessionary environments.
- More generally, we have a historical and common-sense framework to understand how asset classes perform in a variety of economic and market environments, including in cyclical bear markets.
- Moreover, that framework allows us to understand what factors drive the performance of each asset class from one cycle to another (liquidity and interest rates, starting valuations, earnings). Not every cycle is the same.

Second, we factor in our valuation analysis for each asset class. At this point in time, the major asset classes are in neutral territory—neither very attrac-

tive nor unattractive on a long-term valuation basis.

Third, we identify risk parameters for each portfolio. This allows us to accept a certain amount of near-term risk (one-year loss thresholds) in exchange for some flexibility to capture long-term return.

Fourth, we stress test each portfolio type against different possible scenarios in order to assess the amount of downside one-year risk to which we think we are exposing each portfolio. If the stress test suggests that we are taking too much risk, we adjust the portfolio accordingly.

This process today leaves us right where we have been for quite some time: We believe most equity asset classes to be in a fairly priced range—suggesting that throughout the long run, we will make more money there than we would in more defensive asset classes (bonds). We have been rewarded for taking that view, but we have also recognized that, as always, there are troubling risks, including the above-trend earnings mentioned earlier. So we have stayed relatively neutral in terms of our risk exposure. Our analysis supports a continued balance between equity return opportunity and hedging of risks; therefore, we will continue to maintain a middle ground. However, as the economic expansion continues to mature, we will reassess the degree to which we want to hedge against the possibility of recession.

While every cycle is different, what remains the same is our philosophy of structuring portfolios to capture the best long-term return we believe possible, while seeking not to violate the portfolio's one-year risk tolerance. This approach has stood up well throughout time, and is what you can expect from us going forward.

Merchants Trust Definition of Success

Our success can only be defined in terms of how we are able to meet and exceed your expectations. Below are some of the criteria that we use to measure our success:

Service—We provide information on a proactive basis in the manner and frequency requested by you.

Investments—We manage a prudent and diversified investment program, tailored to your situation and guided by your investment objectives. Our long-term performance goal is to exceed the returns generated by a diversified portfolio of Vanguard index funds. In down markets, our objective is to protect and preserve our clients' wealth.

Financial Advice—We are your trusted advisor and seen as an objective and knowledgeable resource, able to provide assistance with important financial issues.

The advisor is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Merchants Trust Company is a wholly owned subsidiary of Merchants Bank. Investments are not FDIC insured, may lose value and are not Bank guaranteed.

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