

Investment Commentary

By David Bosworth, Trust Investment Officer

2007 Retrospective

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed. As credit tightened and the housing market suffered, investors became increasingly worried about the overall economy, triggering stock declines for many consumer goods companies. While all this was happening, U.S. exports were booming and reached an all-time high of 12.1% of GDP (as of 9/30/07). Not surprisingly, companies with significant foreign-based earnings did well, including many energy, technology and materials companies. Overseas stocks also delivered great returns.

There was also action in the bond market. Investors initially worried about inflation and then recession. At times, they worried about both. The 10-year Treasury yield ranged from a high of 5.25% in June to a low of 3.85% in November. The best action was overseas as the dollar's drop gave U.S. investors currency gains that enhanced their returns. But, outside of the government bond market, perceived credit risk rose, leading to underperformance.

For Merchants Trust, it was a year when each of our tactical asset allocation moves added value, versus our benchmarks. Our three asset class plays continue to be:

1. An overweighting to large caps that is funded from a reduction in small-caps
2. A position in emerging-markets local currency short-term bonds that is funded from a reduction in U.S. investment-grade bonds
3. A small position in commodity futures, also funded from investment-grade bonds

Our fixed-income managers added considerable value, versus their benchmarks during 2007. Portfolios using municipal bond funds did not fare as well as the returns of the taxable PIMCO Total Return fund, even on an after-tax basis. However, we would not be surprised to see high-quality tax-exempt bonds make up some of that performance differential during the coming year.

Our international equity managers also outperformed over-



all. However, our domestic equity managers' performance was mixed, with three of our managers (Miller, Nygren and Davis) suffering through poor years.

Our investment decisions are always made based on a multi-year outlook. This allows us to focus on underlying fundamentals and valuations—the factors that ultimately drive returns—and to distance ourselves emotionally from the day-to-day “noise” of the markets and the financial media. During shorter time periods these relationships—between fundamentals, valuations and returns—do not always hold. This is the point made by the legendary Benjamin Graham, saying “In the short-term the market is a voting machine, but in the long term it is a weighing machine.” However, we do pay attention to performance for periods as short as one year because we manage our portfolios based on one-year loss thresholds. These loss thresholds are something we are thinking about as we head into 2008.

2008: Big Worries Any Opportunities?

Looking ahead, the impact of the housing slump and lack of liquidity in the credit markets have increased the level of economic risk, and recession is a clear possibility. We are taking a close look at the risk exposure in our portfolios and assessing whether we should increase our defensiveness. Because our scenario analysis suggests that our portfolios can withstand a normal recession, without violating 12-month risk thresholds, any moves we make are unlikely to be dramatic. However, the possibility of a rough year lies ahead. It should also be understood that this is not an outcome that can be

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What is Your "Boca"?

By David Bosworth, Trust Investment Officer

At a recent conference I had the opportunity to listen to John Brennan, the Chairman of the Vanguard Group, a leading mutual fund company with more than \$1 trillion in assets. The topic of his discussion was how investors measure investment success.

Mr. Brennan told the story of one individual living in Boca Raton, Florida who described his definition of investment success in personal terms. He would like his investment portfolio to work for his family, so that they can continue to enjoy their current lifestyle in Boca Raton. His risk tolerance is not defined in terms of standard deviation of returns or loss thresholds. He defines risk as a forced decline in their standard of living and a reduction of their enjoyment of "Boca".

This individual's definition of investment success was quite different from that discussed at a recent investment committee meeting for a large foundation that Mr. Brennan had attended. Returns for 2006 were being reviewed by the committee of financial astute members. The foundation grew by 12.75%, in comparison to the composite benchmark return of 12.5% (the performance of index funds invested in a manner similar to the foundation) and the return of the U.S. stock market, represented by the S&P 500 Index return of 15.6%.

A discussion followed in which some committee members were unhappy with the returns, some were satisfied and one was overjoyed. Those dissatisfied were concerned that the returns fell below the S&P 500 index return. Their focus was on the lost earnings opportunity resulting from not investing more aggressively. Those satisfied were pleased the foundation's returns were ahead of the composite benchmark.

The overjoyed individual reminded the committee of the investment objective that had been established by the foundation in their investment policy statement targeting a long-term average return of 5% more than the inflation rate. She emphasized that this objective had been established to enable the foundation to accomplish its vital mission, both today and in the future (its "Boca"). A return of 12.75% was well in excess of the return they had determined to be necessary to support their mission.

Most of us have a personal objective for our money. It may be to have a secure retirement, provide financial support and education for children and grandchildren, and/or to support important charitable organizations. Regardless of the objec-

tive, it is important to stay focused on your "Boca" and have a plan that will enable you to get there and stay there. Once the plan is in place, devote your energy to those areas of the plan that can be controlled.

For example, my "Boca" is to be financially worry free by age 60, with sufficient funds accumulated to support an active retirement. Achieving this objective requires a number of important steps, including those listed below:

1. Discuss the plan with my family and make a commitment to work together to accomplish this objective. Include a discussion of the fact that there will be some sacrifice required— a balance of enjoying the present with planning for the future.
2. Determine the amount we need to save and make consistent contributions to my retirement plan and college savings plans.
3. Avoid assuming any additional debt while consistently paying off existing debt.
4. Establish an investment strategy that has a high probability of attaining my desired long-term rate of return in a manner that I can live with daily.

We encourage you to discuss your "Boca" with your account officer. We are here to assist you with the planning, implementing and monitoring that is required for success.

What is next for the Estate Tax?

By Jim Miller, CFP, President & CEO

We are frequently asked for our opinion of what we expect to happen to the estate tax laws. First, let's take a very simplified review of the key provisions of the current law.

Those who die during 2008 can pass up to \$2 million of their assets to their heirs without estate tax. The exempt amount will increase to \$3.5 million in 2009, will be unlimited in 2010 and then will go back down to \$1 million in 2011. The combined federal and Vermont estate tax rate on asset values above the exempt amount is generally in the 45% to 50% range.

For several years now, there has been widespread agreement that the current law is flawed and needs to be changed. The following is a summary of what we believe is most likely to occur:



Timeless Wisdom

By Jim Miller, CFP, President & CEO

I was recently reading *The Intelligent Investor*, by Benjamin Graham with commentary by Jason Zweig, a true classic in the investment world. Below, I have shared a small number of the many gems of wisdom that appear throughout the book. Graham's investment philosophy and principles have been adopted by some of the most successful investors, including Warren Buffett. He is also frequently cited by our fund managers.

- When every investor begins to believe that stocks are guaranteed to make money in the long run, won't the market end up being wildly overpriced? And once that happens, how can future returns possibly be high?
- A great company is not a great investment if you pay too much for it.
- The value of any investment is, and always must be, a function of the price you pay for it. By the late 1990s, inflation was withering away, corporate profits appeared to be booming, and most of the world was at peace. But, that did not mean—nor could it ever mean—that stocks were worth buying at any price. Since the profits that companies can earn are finite, the price that investors should be willing to pay for stocks must also be finite.

- There will be many other domestic and international issues that are likely to take priority over estate tax legislation during 2008.
- Both parties could be embarrassed if the current law is not changed—the Republicans because they created it in 2001 and the Democrats, if they retain control of Congress, because they failed to improve it.
- Changes to the current estate tax laws could occur in 2009 and would likely include phased-in reductions of rates and increases in exemptions. Other possible changes include reunification of the estate and gift tax, and transferability of unused exclusions from a deceased spouse to the surviving spouse.

In the meantime, the convoluted laws make it challenging to plan. Please contact your account officer to discuss your estate plan and to make sure you are positioned properly to address this uncertainty.



- By the rule of opposites, the more enthusiastic investors become about the stock market in the long run, the more certain they are to be proved wrong in the short run.
- As Danish philosopher Soren Kierkegaard noted, life can only be understood backwards, but it must be lived forwards. Looking back, you can always see when you should have bought and sold your stocks. However, do not let that fool you into thinking you can see, in real time, just when to get in and out. In the financial markets, hindsight is forever 20/20, but foresight is legally blind. And thus, for most investors, market timing is a practical and emotional impossibility.
- A century ago, Andrew Carnegie recommended that "you put all of your eggs in one basket and watch that basket." Nearly all of the richest people in America trace their wealth to a concentrated investment in a single industry or even a single company (recent examples include Bill Gates/Microsoft and Sam Walton/Walmart). However, concentration also makes most of the great failures in life. Of the 400 richest Americans in on the 1982 Forbes 400, only 64 were still on the list in 2002. Had they simply earned an average 4.5% return on their assets, they would have remained on the list. During this 20 year period, bank accounts yielded more than 4.5% and the stock market gained an average 13%. Keeping all of their eggs in the one basket that had gotten them onto the list in the first place worked against them during the following 20 years.
- If you live in the US, work in the US and get paid in

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predicted with high confidence. We have been surprised by positive market returns many times through the years. So, we focus on doing our best to maintain adequate risk protection during a one-year time horizon based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns. This common sense approach has served our clients well through the years.

If the current turmoil in the credit markets and/or an economic downturn triggers a severe sell-off, we are likely to see tactical opportunities created in several asset classes or at a stock-picking level. In fact, at a stock-picking level we may already be at this point, with some large financial firms selling far below what their fair value would be if (after the credit crisis abates) their earnings return to normalized levels. However, given the fear and uncertainty, it is likely to be a while before their stocks reflect their longer-term potential. At an asset-class level, we are not there yet—and we may not get there soon—but for long-term investors, market turmoil can create great opportunities.

We know there will always be uncertainty in the markets, but what remains constant for us is our framework for making consistent and disciplined investment decisions.



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US dollars, you are already making a multilayered bet on the US economy. To be prudent, you should invest some of your funds elsewhere—simply because no one, anywhere, can ever know what the future will bring at home or abroad.

- The idea of risk is often extended to apply to a possible decline in the price of a security, even though the price may be of a cyclical and temporary nature, and even though the holder is unlikely to be forced to sell at such times. A better definition of risk is a loss of value realized through actual sale or caused by a significant deterioration in the company's position. Or

more frequently, risk is the result of paying more than the intrinsic worth of the investment.

- Risk exists in another dimension: inside you. If you overestimate how well you really understand an investment, or overstate your ability to ride out a temporary plunge in prices, it does not matter what you own or how the market does. Ultimately, financial risk resides not in what kinds of investments you have, but in what kind of investor you are.



December Benchmark Returns (Preliminary)

	Dec.	4Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	-0.7%	-3.4%	5.4%
Russell 1000 Growth iShares	-0.4%	-0.8%	11.6%
Russell 1000 Value iShares	-1.0%	-5.8%	-0.3%
Mid-Cap Benchmarks			
Russell Midcap iShares	-0.3%	-3.6%	5.4%
Russell Midcap Growth iShares	0.2%	-1.7%	11.2%
Russell Midcap Value iShares	-1.1%	-6.0%	-1.6%
Small-Cap Benchmarks			
Russell 2000 iShares	-0.1%	-4.6%	-1.5%
Russell 2000 Growth iShares	0.6%	-2.1%	6.9%
Russell 2000 Value iShares	-0.8%	-7.3%	-9.9%
Other Benchmarks			
Vanguard Total Intl Stock Index	-2.3%	-1.2%	15.5%
Vanguard REIT Index	-5.1%	-12.9%	-16.5%
Vanguard Total Bond Mkt Index	0.2%	3.1%	6.9%
Merrill Lynch High-Yield Bonds	0.3%	-1.1%	2.2%
Citigroup World Govt. Bond Index	-0.5%	3.9%	10.9%
DJ-AIGGI (Commodity Futures)	4.6%	4.7%	16.2%
JPMorgan ELMI +	0.6%	4.4%	16.0%

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.

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Contact

Merchants Trust Company
 P.O. Box 8490
 Burlington, VT 05402-8490
 Phone: 802-865-1635
 Toll-free: 800-322-2351
 Fax: 802-865-1879
www.mbv.com