merchants TRUST COMPANY

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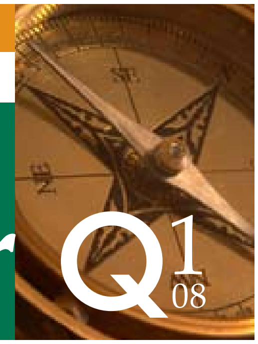

Investment Commentary

By David Bosworth, Trust Investment Officer

Market Overview

Both domestic and foreign stocks were down sharply in the first quarter, with losses on broad indexes in the 9% to 10% range. High-quality bonds gained more than 2%, as investors fled to quality. Commodity futures and emerging-markets local-currency bonds both performed very well in the first three months of 2008, gaining 9.6% and 4.7%, respectively, based on their indexes.

Portfolio Changes

We are implementing some changes to our portfolios during the next few weeks. One change that impacts all but one of our portfolio strategies is the elimination of our positions in commodity futures. The proceeds from this sale will increase our position in emerging-markets local-currency bonds through PIMCO's Developing Local Markets fund. This change is being made because we think the increasing economic weakness, combined with the strong run up in commodity prices in recent months, outweighs the longer-term diversification benefits of owning commodity futures at this time.

We are also eliminating our positions in TCW Select Equities for most clients due to a manager departure. This fund will be replaced with Touchstone Sands Capital Institutional Growth for most portfolio strategies. Additionally, we will be making minor adjustments to the weightings of several other equity managers to improve our overall level of manager diversification.

A Challenging Environment

The overall environment is one that we suspect will continue to be one of the most challenging investment environments we have ever faced. It is probable that we are already in a recession or on the verge of entering one. It is clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs do not help, but are not the primary concern. The problems facing the economy are apparent:

- **Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is still a long way to go. With a massive backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take a year or longer to return to normal inventory levels. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.
- **Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. There is an adverse feedback loop in play, with losses from leveraged entities forcing the sale of assets (deleverage), which triggers more losses, and so on. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps, even more important to a stable economy is the ability to refinance maturing debt. The longer the problem lasts, the more damage will occur to the economy.
- **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see an obvious weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults, as people experience difficulty servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

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What's An Investor To Do?

By Jim Miller, Senior Trust Officer

A fairly typical conversation between investors currently might go something like this:

> "I don't like the recent volatility in the market. It seems the economy will continue to worsen and the stock market is only getting worse."
>
> *"Maybe you should move out of stocks until things settle down?"*
>
> "I'd like to move into something more conservative, but bond and CD rates are so low. And, you never know when the market might turn around. Besides, I already have 40% of my money in bonds."
>
> *"So what will you do?"*
>
> "I guess I'll just hang in there with my current portfolio."

Investment opportunities that provide both principal stability and a high rate of return are not available today. The lack of such an investment is making it easier for investors to stay with a diversified and balanced strategy. Let's take a look at a different period in history when attractive, stable investment alternatives did exist.

1980

In 1980, many investors had an investment opportunity that was too good to pass up— money market accounts and CDs. Not only did you get a great rate (more than 10% and seemingly increasing every day) but your principal was guaranteed not to decline and you did not have to tie up your money.

Compare this to the stock market, which throughout the previous 10 years had averaged only 6% per year, less than the 7.4% inflation rate. The bear market of 1973-1974 was still a painfully recent memory for investors (US stock market declined by more than 40%). And, bonds were coming off three tough years, where principal values declined by 5% per year—a result of increasing inflation and interest rates.

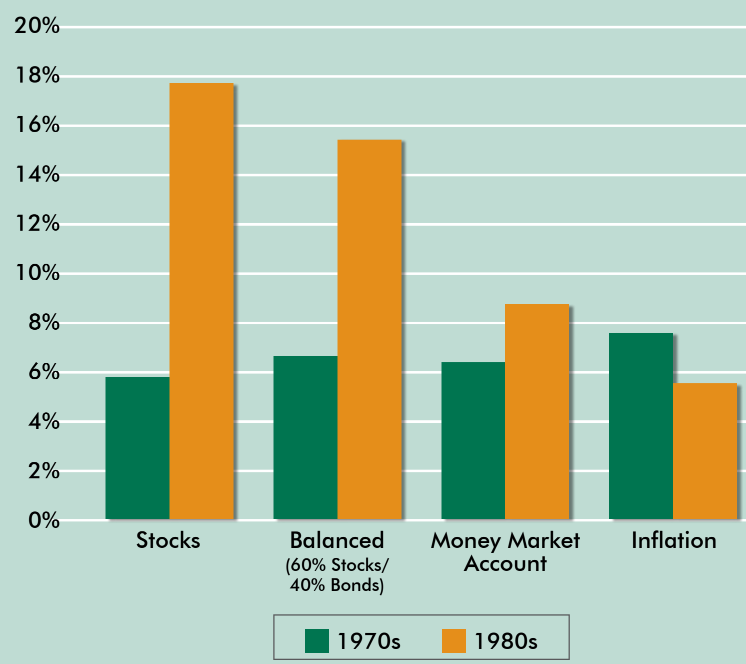
It was an environment where the temptation to abandon a diversified investment portfolio that included stocks and bonds must have been great. Not only had stocks and bonds been performing poorly, but there was plenty about which to worry:

- Chrysler had almost failed, saved only by a government bailout
- Gasoline was hitting an all-time high
- There seemed to be no end in sight to the rapidly increasing inflation
- Our nation's morale was low in the wake of Watergate and Nixon's resignation, and the Iranian hostage crisis had just begun
- If you were in the market for a new home, you could expect to pay 15% or more on your mortgage
- Unemployment rates were high

So, what was the result of that 1980 investment in money market accounts and CDs throughout the course of the decade? CD and money market investments actually did quite well, with an average rate of return in the range of 9%. This would have turned $500,000 into about $1.2 million and is a rate that most of us would be eager to lock in for the next decade if we were able.

And, how did a balanced portfolio of stocks and bonds perform during the 1980s? A balanced portfolio of 60% stocks and 40% bonds averaged 16%, with the worst year at 1% and the best at 27%; it would have turned $500,000 into $2.1 million.

We do not know what the future will bring (and we certainly do not anticipate 16% annual returns) however, the experience of the 1980s is a reminder that what appears to be a superior investment at any point in time does not always result in a best choice for long-term investors.



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Leadership Transition

By Jim Miller, Senior Trust Officer

It has been my privilege to be part of Merchants Trust for close to 20 years, holding most of the positions within our company. During that time I have identified those areas where I believe I can add the most value and that I most enjoy, including: assisting individuals and organizations with their most important financial issues, and assisting staff in servicing their client relationships.

Merchants Trust Company is now at a juncture where the President must focus his or her energies and talents on identifying and managing the company's opportunities for growth. For me to effectively fill this role, I would be required to transfer my client service and technical support responsibilities. Earlier this year, I made an important realization:

1) It would be difficult to find an individual who could service my existing clients as well as I could, given the long-term relationships that have been developed.
2) On the other hand, I was confident we could identify an effective company leader.
3) I value my client contact and would find my job less fulfilling and rewarding if I was no longer actively involved in managing client relationships.

It was clear what made the most sense for both Merchants Trust and for me. I decided to step down from the position of President and CEO and resume the responsibilities of Senior Trust Officer, assuming we were able to find the right leader to take my place. I am pleased to announce that we have found that leader in Molly Dillon. Below, is an introduction to Molly.

Molly Dillon
President & CEO

Molly has 20 years' experience in trust, investment and private banking, with additional experience in executive-level marketing and sales management at Banknorth and Bank of Vermont. She has most recently served as Senior Vice President and Managing Director of the Wealth Management Group at TD Banknorth, based in Burlington.

Molly is former Chair of the Board and recent Campaign Co-chair of the Visiting Nurse Association of Chittenden and Grand Isle Counties. She is a past Board Member of the Greater Burlington YMCA and the Leadership Champlain of the Lake Champlain Regional Chamber of Commerce, and former Regional Trustee of the Vermont Symphony Orchestra. She has served on the Planned Giving Committee of the Greater Burlington United Way, and continues to serve as Campaign Solicitor.

Molly earned a B.A. degree from Cornell University, and is a Certified Trust and Financial Advisor. She completed programs at Northern New England School of Banking and the ABA National Trust School at Northwestern University. Molly resides in South Burlington.

Please join me in welcoming Molly to Merchants Trust Company!

Jim

Back to 2008

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As is often the case, many investors are not sure what to do in our current environment:

- Interest rates for money market accounts, CDs and bonds are low
- The credit crisis, housing downturn and slowing economy have led to tumbling stock prices
- The value of the US dollar is at an all-time low
- The world continues to be a dangerous and unpredictable place

All of these factors combine to create an atmosphere of tremendous uncertainty. The response to this uncertainty for many is to move into more conservative investments—such as, CDs or bonds. However, this is not an exciting alternative given the low interest rates and there is less of a temptation today to abandon a diversified approach than there was in 1980. We believe this is a good thing for the long-term success of investors.

Merchants Trust Company's investment process is designed to manage uncertainty in the financial markets because uncertainty is the norm, rather than the exception. We believe in identifying an appropriate long-term strategy and patiently waiting for opportunities within that strategy. This approach will not avoid periods of declining values, but we believe it is the most prudent approach to long-term accumulation of wealth.

Jim

Investment Commentary

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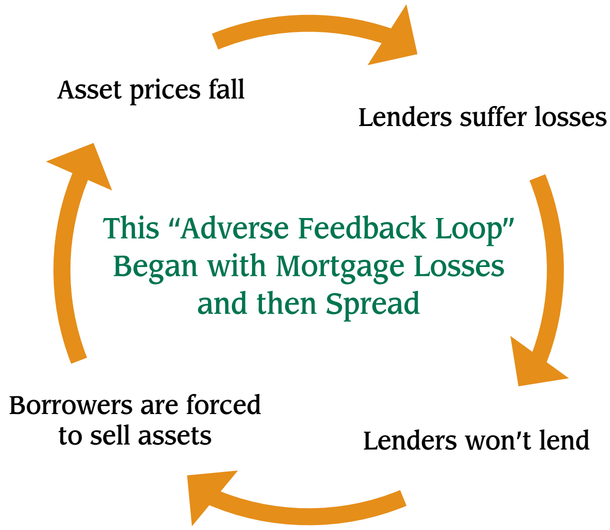

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape, but we do not expect them to be fully immune from economic weakness in the developed world.

As always, there are positives, as well. The biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented action of the Federal Reserve. Though the Fed's moves have not been as effective as they would have liked, they have made it clear that they will do what it takes to stop a major downturn, and they still have weapons in their arsenal, such as the direct purchase of mortgage securities in the public market.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses, versus foreign competitors. Export strength is already happening with exports contributing a significant one percentage point to economic growth throughout the last six quarters (annual rate). This almost offsets the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years.

Weighing the evidence, the odds seem to favor a worse-than-average recession, though that outcome is far from inevitable. Stocks are reasonably valued now, and further declines (depending on the magnitude) could represent an attractive buying opportunity for long-term investors. And, while we believe it is important for us to discuss the more negative possibilities, we reiterate that it is possible that we are close to a bottom, or that we have already reached a bottom. We can not know what the near-term will bring, but at times like this, when economic uncertainty is high, our discipline and research process keep us grounded and gives us confidence in our ability to make sound long-term decisions.

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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