



SUMMER 2010



## trust & investment perspectives



### Rare Birds **by Willard N. Woolbert**

In his book *The Black Swan*, Nassim Taleb explains how the term “Black Swan” came to signify an unanticipated event. In the 17th century, the only swans known to Europeans were white. Therefore, based on that observation, all swans were assumed to be white. When Australia was settled, Europeans discovered that there were indeed black swans. In his book, Taleb details how bias based on limited observations leads to unexpected outcomes.

Our “birds” represent a different bias, having made rare appearances, but are now widely expected to reappear. The first of these is the “double-dip” and the second is “hyper-inflation.” Both of these fowl have been spotted once in the past 70 years but are now expected by different forecasters to appear in the near future. The sightings would be critical, as neither would be good for asset prices.

Since the end of World War II, there has been one instance of a double dip recession. That was in 1980-1982. The first decline was in early 1980 in response to the second oil crisis. The economy showed some strength in the second half of the year and then succumbed to the substantial monetary tightening of the

Paul Volcker-led Federal Reserve. This was the period of 20% short rates and mid-teens yields on long Treasuries.

The Fed’s tightening was in response to inflation that had moved into the 10% plus range and had begun to embed itself in consumer price index (CPI) escalator clauses in contracts and entitlement programs. Higher commodity prices and a dollar crisis in 1979 were important contributors to the surge in prices. Interest rates had to be pushed well ahead of inflation to reduce growth and dampen the expectation of even higher rates of inflation.

The fact that these two “birds” appeared together, and that one probably caused the other, has contributed to the current nervousness surrounding the equity markets in the past quarter. It is highly unlikely that we would see both a second recession and hyper-inflation in this economic environment. It is possible, though we think unlikely, that either will reoccur in the next year.

Since the economic recovery began last spring, there has been much debate about the ability of the U.S. economy to sustain that recovery after the effects of various **continued on page 4**



### General Barry R. McCaffrey, USA (Ret.) to Address International Security Issues at Upcoming Investor Seminar

The United States and its allies continue to face a challenging international environment that requires well-crafted diplomatic and military tools to secure a safe future. Retired General Barry McCaffrey explores these topics at our 7th Annual Investor Seminar in October. At the time of his retirement from the U.S. Army, he was the most highly decorated serving General with over 32 years of service and four combat tours. A dynamic speaker, lauded for sharing practical examples and anecdotes from his wide range of leadership experiences, McCaffrey is a much-sought-after contributor to national newspapers, journals, and television and radio broadcasts. He was a cabinet officer in the Clinton administration, international negotiator, and America’s drug czar for five years. Currently, he serves as security analyst for *NBC News*, adjunct professor of international affairs at West Point, and president of his own consulting firm.



## President's Message: Advance Planning

To be sure, an enduring image of the Summer of 2010, still in its early weeks no less, will be that of oil covered water fowl, soiled beaches and a broken pipe that daily spews 35,000 to 60,000 gallons of crude oil into a fragile ecosystem. The devastating effects of the BP oil spill on the lives and livelihoods of Gulf region inhabitants will not be soon forgotten. Could it have been prevented? The well had a history of problems, seemingly ignored in favor of continued gain. Equally troubling is the ongoing struggle to contain the disaster. With no disaster plan in place, officials grasp for solutions.

In another part of the world, after months of debate, a solution to the Greek debt crisis is emerging, as the European Union steps in with an aid package. This fiscal nightmare, also unplanned for, is forcing a reconfiguration of European monetary policy. In exchange for financial aid, Greece relinquishes control of economic policy to the eurozone ministers and the International Monetary Fund and becomes a test case for other struggling EU countries such as Spain and Portugal who teeter on the edge of instability. Many believe that Europe must now

move toward coordinated fiscal policies in order to maintain a monetary union.

Could this sovereign debt crisis have been avoided? One could argue that a quick look at fiscal deficits, dangerously out of proportion, would have been an early indicator. Many European countries are reacting to this intervention and moving to rein in debt, pulling back on spending and implementing austerity measures to stem further crisis. The pace of the global economic recovery will no doubt be impacted.

America also faces daunting choices as a growing and excessive national debt foreshadows the possibility of our own fiscal crisis if plans for financial reform are not put into place. Our nation's leaders will need to overcome divisive partisanship in order to collectively work toward solutions.

Bill Woolbert offers a more definitive look at the economic future in his reflections for this issue. And Tax Administration's Randy Thomas turns a practiced eye toward health care reform and possible tax implications. I am certain that you will gain insight from both articles.

There are lessons to be learned

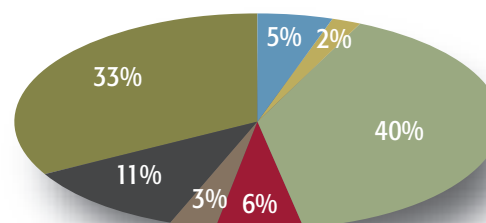
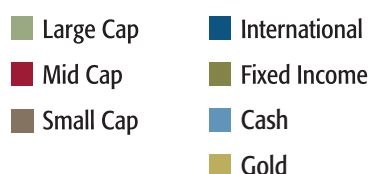
from crisis. Clearly short-term gains, however gratifying, can fall victim to shortsightedness. Things can go wrong. One need not look any further than the 2008-09 market. At Pennsylvania Trust, we have never chosen quick fixes or speculation over the wisdom of long-term investment. We are thoughtful and careful, managing our clients' assets with integrity and foresight. A carefully maintained balance of preparedness and perspective has served us well and we continue to choose that path.

While the senseless tragedy of the Deepwater Horizon rig disaster will linger with me, I am buoyed by the resilient spirit of people around the world. In South Africa, a country faced with innumerable crises, social and economic, the world gathered for World Cup Soccer. The buzzing of the vuvuzelas and the proud faces of athletes and fans from many countries, remind us that, despite challenges, there is much to be celebrated.

**Richardson T. Merriman**

*President and Chief Executive Officer*

### Balanced Asset Allocation



## TRUST TALK

## Looking Ahead: Health Care Reform and Resulting Tax Implications

by **Randy G. Thomas, CPA, CFP®**



In late March, the long debated Health Care and Education Reconciliation Act of 2010 became law. The controversial bill's intent is to contain soaring medical costs and cover more uninsured Americans. In fact, beginning in 2014, individuals who do not maintain a minimum level of health care coverage will face a penalty tax. Health care reform comes with an array of complex rules; phase-ins and phase-outs and non-compliance penalties, depending on your income and medical coverage. It also comes with tax increases.

This new law includes over \$250 billion in new taxes, the majority of which will impact higher income taxpayers. Starting in 2013, high-income investors and wage earners will see their federal taxes increase, in some cases significantly. On January 1, 2013, a new tax on investment income will be assessed on high-income investors. The new Medicare Contribution Tax, which will be used to fund health care expansion, is a 3.8% flat rate and applies to an individual's eligible investment income. Investment income encompasses capital gains, dividends, interest, royalty and rental income.

The tax is levied on the lesser of net investment income or the amount by which your adjusted gross income exceeds \$200,000 for single filers, or \$250,000 for married couples filing a joint return. For example, consider a married couple with adjusted gross income of \$275,000, including net investment in-

come of \$30,000. The calculation is made by taking the lesser of investment income, in the amount of \$30,000, or the amount by which the adjusted gross income exceeds \$250,000. The resulting \$25,000 is subject to a 3.8% tax, or \$950.

High-income taxpayers who have investment income and wage earnings or self-employment income are doubly impacted. Starting in 2013, there is an additional Hospital Insurance Tax of .9% on wages, and or self-employment income over \$250,000 for married couples filing jointly or \$200,000 for single filers. This tax is in addition to the 1.45% Medicare Tax currently assessed on wages and earned income. Employers are responsible for withholding this additional tax from employee wages. Unlike the 1.45% Medicare Tax currently being charged, the employer is not required to pay in an equal amount as this tax affects the employee only.

Here's where it gets more complicated. Suppose both spouses are employed and neither earns wages over the applicable threshold. If each spouse's wages are \$200,000, under the \$250,000 limit, their respective employers are not required to withhold the additional .9% tax. However, when their joint tax return is filed, the wages total \$400,000, \$150,000 over the \$250,000 joint filing threshold. As a result, an additional \$1,350 of Hospital Insurance Tax is owed.

It is important to note that both the Medicare Contribution Tax and the Hospi-

tal Insurance Tax will be subject to Federal Income Tax withholding rules. They will count as taxes for determining any underpayment penalties, meaning these taxes must be paid through additional payroll withholdings or quarterly estimated tax payments.

In anticipation of these tax increases, high-income investors may want to recognize large capital gains in a particular stock before the law goes into effect in 2013. If warranted, the taxpayer can buy the stock back and pay the capital gains before the additional taxes kick in. The taxpayer also receives an increase in the cost basis. Municipal bonds may be another option for high-income taxpayers to minimize additional taxes, as municipal income is not counted toward the taxpayer's adjusted gross income. Employees expecting a large bonus in 2013 should consider accelerating payment into 2012.

At Pennsylvania Trust, our experienced staff of tax professionals closely follows tax legislation and works diligently to keep our clients aware of the implications they, as individuals, might experience as a result of changes in old laws or new legislation. It is not too early to initiate a discussion with us to review your portfolio, ensuring that you remain well positioned to achieve your financial goals.

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*Mr. Thomas is Senior Vice President, Tax Administration, at Pennsylvania Trust.*

**continued from page 1** government stimuli play out. While generally strong economic results in the first quarter pushed concern about a second decline into the background, more recent economic data and circumstances around the world have reignited concern about a failing recovery. This began with the recognition that growth in China was slowing. China's economic recovery has been critical to the global recovery and fear that China was decelerating created worry that growth in the developed world would suffer as well. This fear was compounded by the problems in Europe. It was expected that the financially impaired PIIGS (Portugal, Italy, Ireland, Greece and Spain) would have to reduce government deficits and thus reduce growth in their economies. This seemed manageable as their combined impact on growth was small. However, first Britain and most recently Germany proposed austerity budgets, making the growth impact larger. A shrinking Europe, with a weaker Euro as well, puts a great deal of pressure on the U.S. to sustain growth. Lastly, economic numbers in the U.S. have turned weak. Consumer spending has slowed from the first quarter pace and, ominously, employment figures have not improved. The May and June employment reports showed only token gains in non-census related jobs and initial unemployment claims have stalled at an elevated level. Slower growth globally, currency compe-

tion for U.S. manufacturers, and weak consumer spending are not a good combination for domestic growth.

The colossal growth in the money supply and record budget deficits have led some to anticipate the return of hyperinflation. Our view is that this is very unlikely in the current environment. What is most important is that these excesses have occurred when private credit demand is falling. Deleveraging is occurring everywhere outside the government, reducing the impact of the surge of money and the impact of the government demand for credit. This will not go on forever, and will prove to be a problem when private credit demand returns. But with substantial excess labor capacity in the U.S., it is hard to see inflation becoming a near-term concern. If we do see increases in the CPI it will come from what we will call "imported inflation". Growth in the developed economies has been weak, but strength in the emerging markets of China, India, and Brazil has been robust. This growth has and will put price pressure on inputs to their growth, such as commodities, that appear unwarranted if we look just at our needs.

Secondly, we have seen much written about labor strikes in China for higher wages. Wages are going up elsewhere in the emerging world as well. Historically, productivity has off-set this and the emerging world was able to export goods at lower prices. But as recently as 2007,

China's export prices were rising. While the dollar has strengthened against the Euro it has been falling against Asian currencies. Most prominent has been the debate over the value of the yuan. We would like the yuan higher to make our exports more attractive but a consequence of this would be to make the goods we import, mostly consumer goods, more expensive.

Going forward, growth will be a bigger issue for the markets than inflation. The process of reducing debt, first in U.S. housing and now in budget deficits in Europe and in U.S. state and local governments, is a very different dynamic than has been present in post-war economic rebounds. The importance of Chinese growth to global growth is a new and less predictable variable in evaluating the economy. Until the markets better understand the impact of fiscal restraint, the vagaries of Asian economies in times of stress, and spending in a deleveraging world, the fear of a "double-dip" in the global economy is likely to dominate the markets. This is likely to be a frustrating and volatile summer.

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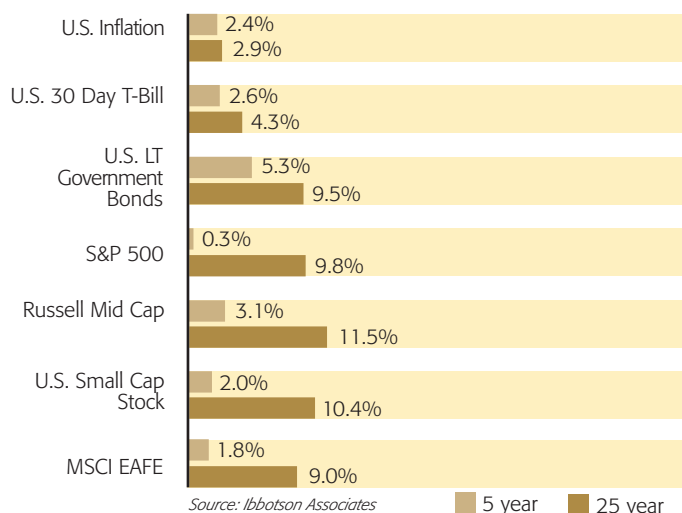
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# Market Indicators

	Current	Three Months Ago	One Year Ago
<b>Stock Indices</b>			
Dow Jones Industrial Average	6/30/10 9,774	3/31/10 10,857	6/30/09 8,447
Standard & Poor's	1,030	1,169	919
<b>U.S. Treasury Yields</b>			
2 Year	0.6%	1.0%	1.1%
5 Year	1.8%	2.5%	2.5%
10 Year	2.9%	3.8%	3.5%
30 Year	3.9%	4.7%	4.3%

## ANNUALIZED RETURNS OF SELECT ASSET CLASSES



## CORE LARGE CAP DIVERSIFICATION

In order to maintain a well diversified large cap common stock portfolio, we recommend the following relative sector weightings within the Standard & Poor's 500:

S&P 500 Sector Weightings	Pennsylvania Trust	
Consumer Discretionary	10.3%	—
Consumer Staples	12.1%	=
Energy	10.2%	=
Financials	16.7%	—
Health Care	11.7%	=
Industrials	10.1%	=
Information Technology	19.1%	+
Materials	3.3%	+
Telecommunication Services	2.9%	=
Utilities	3.6%	=

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