

Are there Still Opportunities to Invest in Bonds?

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Volatility in the capital markets has been elevated since Federal Reserve Chairman Bernanke addressed the Joint Economic Committee of Congress during May, suggesting that the Federal Reserve may begin to reduce its commitment to the purchase of long term bonds as early as the fourth calendar quarter of 2013. Stocks and bonds both declined initially, and have since recovered some or all of the lost ground. Investors were reminded that our recent history of low and declining interest rates will come to an end. Indeed, investors should be prepared for lower returns from investments going forward, as we are still starting from a point of historically low interest rates and price-earnings (P/E) ratios which are in line with their longer term average. Few asset classes appear to be trading at bargain prices.

We are more optimistic about the longer-term outlook for stocks, given our expectation for a continuation of earnings growth as the global, developed economies recover. Profit margins of European corporations are still below average and revenue growth in the June quarter was positive after four quarters of a flat or declining trend. Recent measures of business confidence in Germany, Japan and the U.S. (small business) have moved higher. Japan has witnessed a 4% jump in real GDP during the first half of this year, responding to the prospect of stimulus measures from a new Administration. Manufacturing indexes in the U. S., Europe and China have recently ticked up. Hence, we believe global real GDP growth is likely to accelerate modestly in 2014.

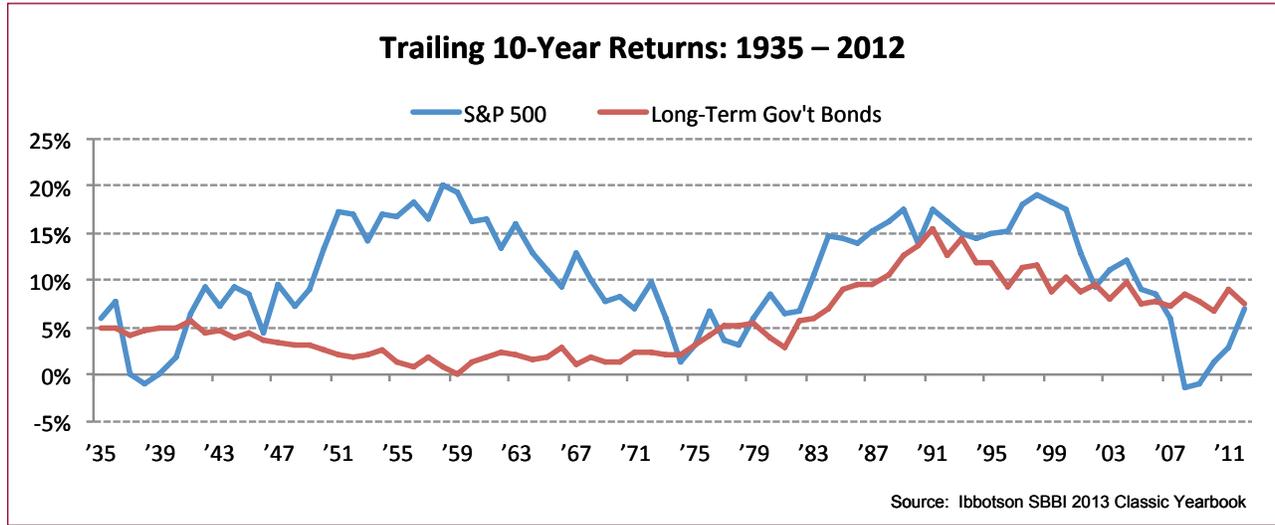
In 2012, bonds completed a long journey of favorable returns. Indeed, since the end of 1982, the return for government bonds over every 10-year period has exceeded the median 10-year return (4.9%) calculated from the 10-year period ending 1935. The favorable returns cover a span when the interest rate on 10-year government bonds dropped from over 14% to under 2%. Moreover, since 2007 10-year bond returns have exceeded those of stocks (See Chart 1), a stretch only observed once before since the 1930s. In this article, Eric Jussaume outlines the risks related to interest rates and credit problems as well as the attendant opportunities. While prospective returns will be more challenging, bonds remain a viable deflation hedge and offer relative safety of principal and a reliable income stream.

So far 2013 has been unfriendly to bond investors. Through September 30, 2013 all major fixed income indexes are reporting losses, with the largest losses reported in longer maturity and sovereign securities. The Barclays Treasury 20+ Year Index has returned -11% while the Barclays Sovereign Index of international government bonds is down -8.15%. Investors in shorter maturity securities have suffered losses as well, but not nearly as severe as longer dated securities. The Barclays Government/Credit Index, a benchmark we use internally, has declined -3.05%. Since the beginning of the year, the yield on the 10-year U.S. Treasury has risen from 1.76% to 2.61%, an increase of 85 basis points (bp), and the

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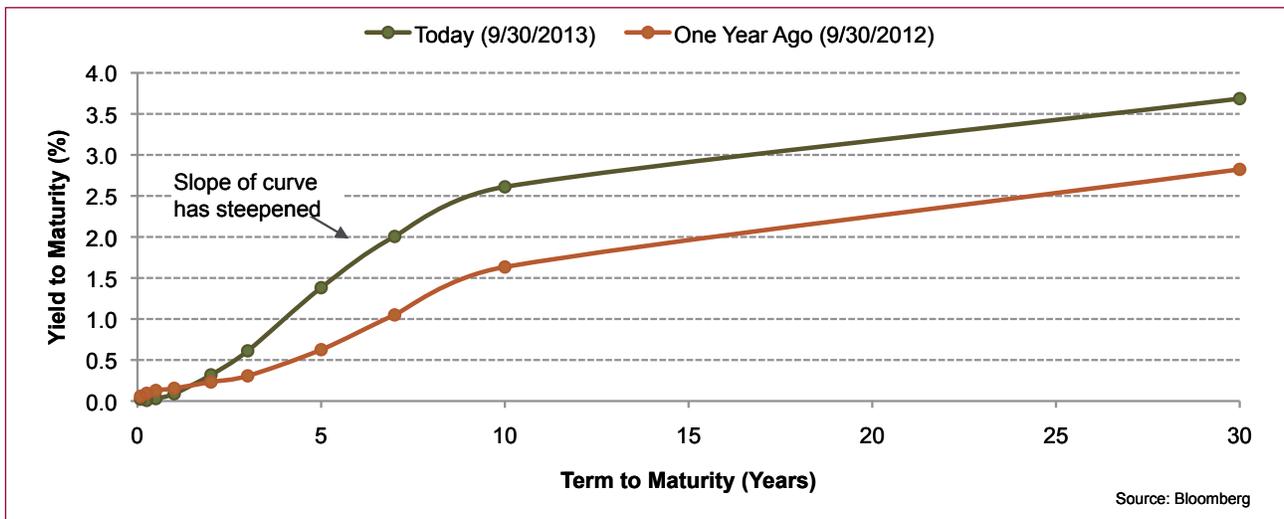
Chart 1



5-year U.S. Treasury has increased to 1.38% from 0.72%, up 66bp. However, the 2-year U.S. Treasury is up only 7bp, from 0.25% to 0.32%. This movement of yields, whereby longer maturity rates increase by substantially more than shorter rates, has steepened the yield curve. Traditionally, steep yield curves have been associated with stronger economic activity.

may be reduced or “tapered” in the fourth quarter also caused rates to rise. In an effort to keep rates low, the Federal Reserve has purchased \$3.2 trillion in fixed income securities since the first asset purchase program was announced in November 2008. The following Chart 2 illustrates the change in U.S. Treasury yields over the past 12 months.

Chart 2



Indeed, from the beginning of 2013, the U.S. economy has steadily improved. Although not as robust as previous recoveries when measured by gains in real GDP, indexes of home prices, auto sales and manufacturing have continued to gain. Recent remarks by Federal Reserve Chairman Ben Bernanke that the Federal Open Market Committee’s asset purchase program, known as Quantitative Easing 3 (QE3),

In addition to the uncertainty caused by tapering comments from the Federal Reserve Chairman, on July 18, 2013 a major municipality, the City of Detroit, filed for bankruptcy. As the City had been experiencing a deteriorating economy since the 1970’s, we were not surprised by the bankruptcy filing. Over the past fifty years, the city’s population shrank by over 50%. According to The Economist (July 27, 2013), Detroit’s \$18.2

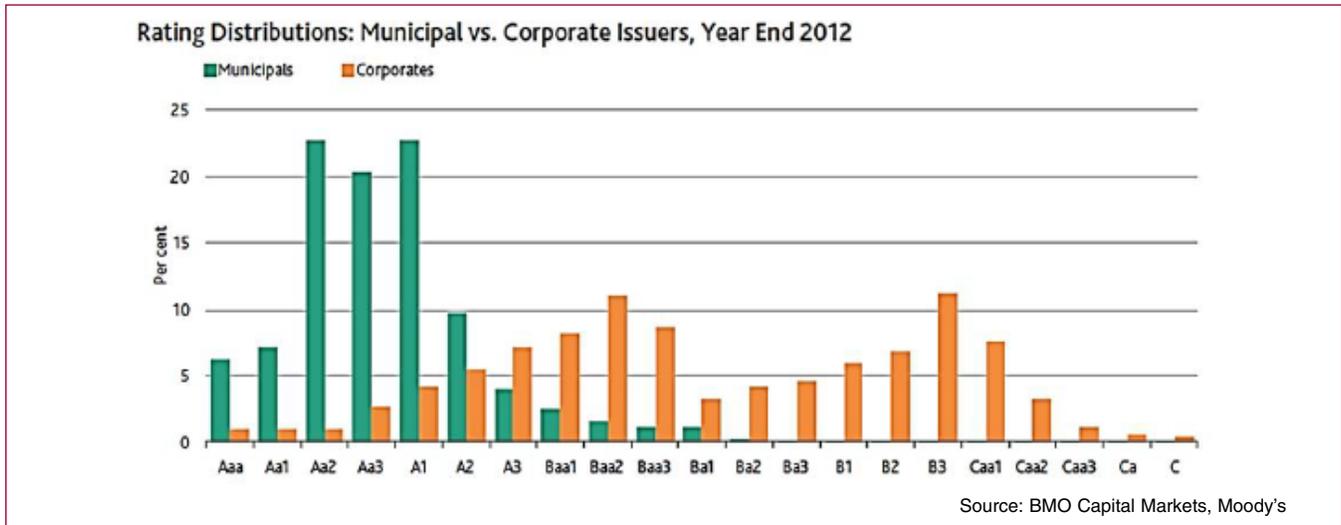
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billion in long term debt, consists of \$9.2 billion in unfunded retirement benefits. Since 2004, when Detroit's credit was rated Baa1 by Moody's and A- by S&P, its credit has been downgraded several times by each agency to its most recent Caa2 (Moody's) and CCC- (S&P) rating, a junk bond or non-investment grade rating. The emergency manager of the city, appointed by the governor, seems prepared to argue that

one of the major credit rating agencies, on defaults from 1970-2011 shows an average default rate of approximately 0.03% in 2010 and 2011 for the better than 17,000 issues rated.

Presently, large redemptions from bond mutual funds have contributed to a rise in longer term rates. Mutual fund and insurance companies are traditionally large buyers of longer-

Chart 3



the city's general obligation bonds (GO) should be treated as unsecured obligations, whether or not they are supported by an unlimited tax pledge. If upheld, this would set a worrisome precedent for holders of other GO bonds. Although owners of Detroit's debt will not know the final status of their holdings for several months, bond investors are currently demanding higher than average yields from any municipal bond issues within the State of Michigan.

Municipal bankruptcies are well telegraphed and fairly unusual. Unlike cities and towns, state governments may still default, but are not allowed to file for bankruptcy. Chart 3 illustrates the credit ratings of municipal bonds versus corporate bonds. The average rating of approximately 16,000 municipal issuers is Aa3; 93% of rated municipal issuers are rated A3 or higher compared to 23% of global corporate issuers. The major difference between corporate debt and municipal debt is the municipality's ability to raise taxes. All states, with the exception of Vermont, are required to balance their budgets annually. A March 7, 2012 study by Moody's,

dated bonds. Their trading activity can impact the market, for example, when they are forced to sell their positions to meet investor redemptions as rates rise. This selling in turn may precipitate a ripple effect down the yield curve, as rates on intermediate term bonds have also risen.

Cambridge Trust continuously runs quantitative screens on our bond holdings to search for improving and declining trends. Our research suggests the recent sell-off may be an opportune time to add exposure to high quality municipal bonds. Outside of intermediate term maturities, municipal bonds are now yielding more than 100% of the pre-tax U.S. treasury yield, usually an attractive entry point. This advantage is augmented on an after-tax basis given the exemption of municipal bond income from federal income taxes. (See Chart 4)

The corporate bond market has also experienced some disruption during the recent increase in interest rates. The spread on corporate bonds, which is the incremental yield

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Chart 4

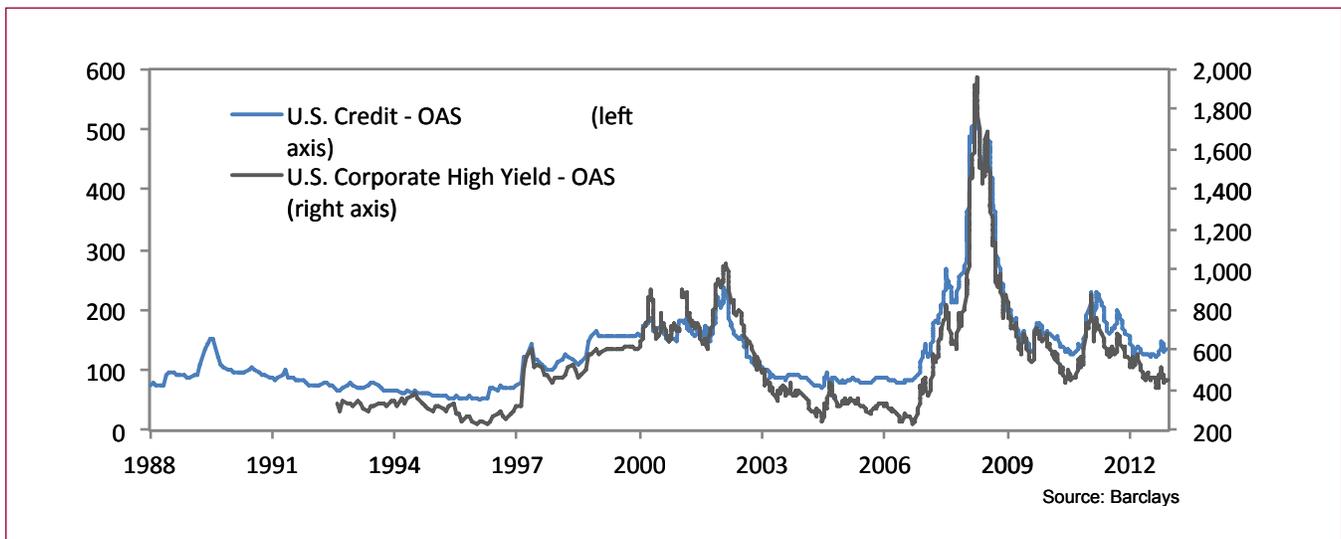
	AAA Muni	U.S. Treasury	Municipal % Treasury	Average 9/29/2005-9/30/2013
2 Year	0.36%	0.30%	120%	98%
5 Year	1.32%	1.38%	96%	90%
10 Year	2.54%	2.61%	97%	94%
30 Year	3.75%	3.69%	102%	97%

Source: MMD and Bloomberg

pickup over the corresponding maturity in U.S. Treasuries, has also recently widened. This is a sign that investors are

construct bond portfolios with a below-benchmark maturity or duration. These shorter duration bonds typically exhibit

Chart 5



demanding more yield to take on riskier assets. Chart 5 shows the spreads of both high yield (non-investment grade) and investment grade rated debt. The current spread is wider than in the 2005-2007 time period, but significantly lower than in 2008-2009 financial crisis. We believe corporate bonds remain attractive relative to U.S. Treasuries. With corporate balance sheets in healthy financial shape and the potential for the economy to strengthen, there is a good case for the yield difference or spread between corporate bonds and Treasury securities to further contract, leading to relative outperformance by corporate bonds.

At Cambridge Trust, our strategy for some time has been to

lower volatility whenever rates rise, as well as affording us the opportunity to reinvest maturing bonds into higher yielding securities. At current rates, we find the 5-8 year range of the maturity spectrum to be particularly attractive for corporate bonds. With these securities an investor can achieve between 50-70% of the yield available on similar bonds of 20-30 year maturities. With regard to municipals, high quality issues at current yields are attractive. As always, we continue to maintain a very thorough and diligent process when selecting securities. Our mandate is to protect principal while delivering an optimal income stream for our clients.

New Taxes You Should Know About

By Michael P. Panebianco, Vice President and Trust Officer, 603-369-5053

Enacted back in 2010, The Patient Protection and Affordable Care Act did many things. To offset the cost of health care legislation, it created two new surtaxes on high income taxpayers: a 3.8% tax on Net Investment Income (“NIIT”) and a 0.9% increase to the Medicare Tax.

The NIIT went into effect on January 1, 2013 and it affects individuals, trusts and estates. However, it does not affect income tax returns for the 2012 taxable year that are filed in 2013.

The 3.8% NIIT applies to individuals if they have “net investment income” and their modified adjusted gross income is over the following thresholds:

Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widow(er) with dependent child	\$250,000

What does this mean? First, you need to determine the amount of your “investment income,” which generally includes, but is not limited to, interest, dividends, capital gains, rental and royalty income, non-qualified annuities, and income from businesses involved in trading of financial instruments or commodities. Interest from tax exempt municipal bonds as well as the gain on the sale of a principal residence that is excluded from income under Section 121, are excluded from net investment income for this calculation. Next, to calculate your “net investment income,” the investment income is reduced by certain expenses properly allocable to the income, such as investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in the net investment income.

Once the net investment income has been calculated, the 3.8% NIIT will apply to the lesser of (i) the net investment income, or (ii) the amount that the adjusted gross income exceeds the applicable threshold amount. For example, a single taxpayer who has \$30,000 of net investment income and an adjusted gross income of \$210,000 will pay the 3.8% NIIT on \$10,000 because \$10,000 is the lesser of the adjusted gross income over the \$200,000 threshold for single individuals and the amount of the net investment income.

Trusts and estates are also subject to the NIIT if they have undistributed net investment income and also have adjusted gross income over the dollar amount at which the highest tax bracket for a trust or estate begins for such taxable year (for tax year 2013, this amount is \$11,950). The computational rules are different for certain types of trusts, such as an Electing Small Business Trust; and other trusts are exempt from the NIIT, such as trusts that are classified as a “grantor trust” for tax purposes.

The NIIT is calculated on IRS Form 8960 for both individual and trusts and estates and is attached to Form 1040 (for individuals) and Form 1041 (for trusts and estates). The NIIT is subject to the estimated tax provisions, so affected individuals, trusts and estates may need to adjust their estimated tax payments accordingly.

The new Medicare (surcharge) Tax on earned income is an additional 0.9 % tax that applies to individuals’ wages, other compensation and self-employment income over the following thresholds:

Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widow(er) with dependent child	\$250,000

How does this work? Presently, the Medicare tax applies to all wages and self-employment income. For wage earners, both the employer and employee pay 1.45%, whereas a self-employed taxpayer pays the entire 2.9%. The new Medicare Tax is a 0.9% tax, in addition to the 1.45% or 2.9%, for wages, other compensation, and self-employment income over the applicable threshold amount, causing the total Medicare tax on wages over the applicable threshold amount to be 2.35% or 3.8%, depending on whether it is self-employment income, instead of 1.45% or 2.9%, respectively.

Due to the nature of the tax, the Medicare Tax applies only to individuals; it does not apply to trusts and estates. In addition, the NIIT and Medicare Tax are independent of each other, so an individual can be liable for both taxes.

Goodbye to DOMA?

By Alice J. Flanagan, Trust Officer, CTEA, CFP®, 617-441-1442

If you have turned on the news lately, you may very well have heard about DOMA. This summer, this particular acronym became a household term because of a court case involving a same-sex married couple and their lawsuit regarding an estate tax refund.

DOMA stands for the Defense of Marriage Act, which was enacted on September 21, 1996. Section One titles the enactment as DOMA. Section Two addresses the power reserved to each individual state to recognize the same-sex marriages of other jurisdictions. **Section Three, which defines marriage as “a union between one man and one woman” was recently invalidated.**

The District of Columbia and thirteen states recognize same-sex marriages. Massachusetts is indeed one of them. The first court decision giving same-sex couples the constitutional right to marry took place in Massachusetts in 2003 (Goodridge v. Department of Public Health). Several states decided to follow Massachusetts and recognize same-sex marriages, while others recognize same-sex marriages of other states, civil unions and/or domestic partnerships. However, in the years following the decision, there were numerous state cases that were overturned and left the determination of the term marriage to the legislature. The remainder of the states enacted similar legislation to DOMA and stood their ground against same-sex marriage.

In November 2010, Edith Windsor, widow of Thea Spyer, sued for an estate tax refund of approximately \$363,000 (United States v. Windsor). Edith and Thea were a couple for over 40 years. They were married in Canada in 2007. Thea died in 2009, leaving her estate to Edith, but was denied a marital deduction for estate tax purposes. As a result of this court case, on June 26, 2013, by a 5-4 decision, the Supreme Court found Section Three of DOMA to be unconstitutional.

Although the Supreme Court decision allows for same-sex marriages to be recognized on a federal level, the issue of whether there is a valid marriage is a matter of state law. Questions remain where a couple was validly married in one state, but currently resides in another state that does not recognize same sex marriage. The answers to these questions have far reaching implications in areas ranging

from spousal benefits to tax planning. Certain agencies have already provided guidance. Unfortunately their approach thus far has not been entirely consistent. Social Security and Medicare/Medicaid benefits will be provided to same-sex married couples based on where they reside. Under this approach, a couple wed in Massachusetts now living in South Carolina would not qualify for spousal benefits. Conversely, immigration and military/veteran benefits will be determined by the state in which you were married. That same couple now living in South Carolina denied social security spousal benefits would qualify for veterans' spousal benefits. The IRS similarly ruled that same-sex marriages will be recognized for federal tax purposes based on the state in which you were married. Using the example of that same couple, they would file their Form 1040 as married, but presumably would file their state income tax returns as single individuals. Most recently on September 18, 2013, the Department of Labor issued guidance indicating the place of marriage controls in administering employee benefit plans governed by ERISA. The situation is still fluid, and by the time you read this article there may be additional developments.

Numerous income, estate, and gift tax implications must be considered with the invalidation of this Act. Same-sex married couples' filing status will be either joint or married filing separately. Income that was previously reported on separate returns may now be reported on a single joint return. This will affect tax brackets, exemptions, deductions, thresholds and ceilings. Same-sex couples will now be able to take advantage of the higher capital gains tax exclusion for the sale of a personal residence.

If you are the beneficiary of your spouse's IRA, you will be able to roll it over into your own IRA rather than having an inherited IRA for your benefit, which was the rule in the past. This is a major advantage for most married couples because of the required distribution rules. Beneficiary designations on your retirement accounts may need to be reviewed in order for your spouse to take advantage of this benefit.

Numerous estate planning vehicles will be available to same-sex married couples as a direct result of the recent invalidation. As a married couple, you will also be eligible to participate in “gift splitting.” For the 2013 tax year, married

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couples are able to gift \$28,000 rather than the single annual exclusion amount of \$14,000 to any one person. Lifetime transfers between spouses can be made free of gift tax concerns. In addition to lifetime transfers, you will be able to pass assets to your spouse after death, free of estate tax, due to the unlimited marital deduction. Portability elections for unused exemptions between spouses will now be available. Certain wealth transfer planning techniques for married couples that were previously not applicable will be

increasingly popular among same-sex married couples.

The invalidation of Section Three of the Defense of Marriage Act is likely just the very beginning of what is known as the DOMA effect. With the law evolving at the national and state levels, there are adjustments and reviews that need to be made currently and in the future for tax and estate planning. It is important to be fully informed and discuss these implications with your professional advisors.

Cambridge TrustLetter *Editor – Laura C. McGregor*

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Fall 2013

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