

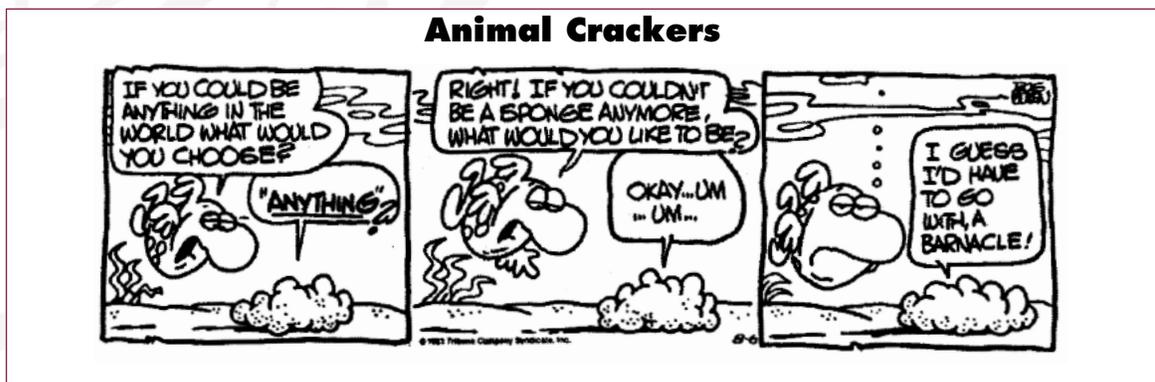
## Sinking Into Optimism

By James F. Spencer, CFA, Chief Investment Officer, 617-441-1505

In this article, we are going to ask you to use your imagination to contemplate the future. It may be more difficult than you think. In his book, “Stumbling on Happiness,” Daniel Gilbert, a psychologist, describes how our imagination is trapped by “boundaries of the present.” He refers to a 2003 research paper where two groups of people working out at a gym were asked to imagine how they would feel if they became lost while hiking and had to spend the night in the woods with no provisions. When asked to predict whether their hunger or thirst would be more unpleasant, 92% of the people in the first group, who had just come off the treadmill, predicted that thirst would be more unpleasant. In the second group, who made their prediction before going on the treadmill, 61% predicted that thirst would be more unpleasant. “...What we feel as we imagine the future is often a response to what’s happening in the present.” In the cartoon below, the sponge cannot fathom a world beyond the ocean floor.

At the end of the 1970s, after the Arab oil embargo and a decade of rising inflation culminating in an interest rate on the 10-year Treasury note approaching 16%, who would have imagined a day when the 10-year Treasury would yield less than 1.5%? My first 30-year home mortgage was over 15% in the early 1980s, compared to today’s rate of less than 3.5%. By 1998—the year after Steve Jobs returned to run Apple following a twelve-year hiatus—Apple had experienced two years of substantial losses and massive layoffs. The company’s stock price was under \$5 per share and its total sales were under \$10 billion. Today its stock price is over \$600 per share and its sales are approaching \$200 billion. Judging by market value, Apple is the most highly valued company in the world. Who would have predicted this future? According to Gilbert, “We cannot feel good about an imaginary future when we are busy feeling bad about an actual present.”

A 1983 Animal Crackers Cartoon reprinted in Gilbert’s book (pg. 139):



continued on page 2

## Sinking Into Optimism *(continued)*

Our challenge as investors is to realize that future stock prices and market returns will be based on how we feel in the future, not on how we feel today.

### Feeling Bad About the Present

A look at the current economic climate, as portrayed in today's headlines, can understandably make you feel bad about the present. In an interview with the *New York Times* (August 12, 2012), a reporter summed up the comments of John Bogle, former head of the Vanguard complex of mutual funds as follows: "This is the worst time for investors that he has ever seen" in more than sixty years in the business.

Referenced seven times in print articles in 2009, it is now mentioned at least once daily. While slightly larger than Ireland and Portugal, Greece's economy is one-fifth the size of the United Kingdom. Indeed it is smaller than that of the state of Michigan. The financial implications of Greece leaving the Eurozone are still unknown, yet the coverage seems to predict disaster.

Growth in the emerging markets, which have been the locomotive of the global economy, is clearly slowing. The International Monetary Fund has lowered its forecast for 2012 GDP expansion in the emerging markets to 5.6%,

Table 1. References to "Greece debt crisis" from 2009 – 2012 (September):

	2009	2010	2011	2009 to 2011	2012 (Sept)
WSJ Print Edition	7	512	616	1,135	324
Digital Media <sup>1</sup>	119	1,771	2,848	4,738	1,704

<sup>1</sup> Includes: WSJ.com, Barron's, SmartMoney, DJ Newswires, MarketWatch, All Things Digital

Looking at the list of worries, Europe has been there the longest. The economic challenges in Europe are real and have received wide circulation. The unemployment rate in the 17-country Eurozone reached 11.4% in August, an all-time record. The closely watched Purchasing Managers Index (PMI), a gauge of industrial activity, has recorded a level below 50 for each of the past fourteen months through September. An index level of 50 serves as the line of demarcation between expansion and contraction. The Gross Domestic Product (GDP) in all the major Euro countries is still below the peak reached prior to the 2008-2009 recession, with the exception of Germany. A survey of forecasts from economists and strategists tracked by Bloomberg calls for a contraction in real GDP of 0.5% in 2012 compared to a projection of 1.5% growth made only fifteen months ago.

The level of support from the European Central Bank to help countries such as Greece and Spain refinance their debt is forever being debated. Indeed, the focus on Greece and its questionable commitment to fiscal austerity seems to exceed, in proportion, the size of its economy. We surveyed the number of times the term "Greece debt crisis" appeared in articles published in both print and digital media formats by just the *Wall Street Journal*. The results are in Table 1.

approximately 2.0% below their rate of growth in 2010. Brazil is barely in positive territory and the government in India has been plagued by charges of corruption in the awarding of telecommunication licenses and coal contracts, not to mention the threat of power outages.

The situation in China bears the closest scrutiny, given its position as the second largest world economy. While China recorded a real GDP gain of 7.4% in the third quarter of 2012, some recent data points are not encouraging. China's PMI index has been below 50 for 11 consecutive months through September. Corporate activity in China is also subdued, resulting in weak profits and reduced demand for global industrial commodities. BHP, the globe's largest diversified miner, has halted a \$20 billion capital spending program to expand the production of copper and uranium in Australia. Companies such as Deere, Cummins, Caterpillar, and Nike, as well as some luxury goods retailers, have recently reduced their expectations for sales growth in China. The murky situation in the country is evidenced by the downward spiral in the Shanghai Composite Share Index, which was recently at its lowest level since the 2009 market bottom. While several major cities in China have announced local stimulus programs to prop up the economy, there is speculation that local government indebtedness will limit the

## Sinking Into Optimism *(continued)*

actual funds available. In an interview with the *Financial Times* (August 20, 2012), Doug Oberhelman, the CEO of Caterpillar referred to the global economy this way: “There’s never been a more unpredictable set of tea leaves than right now.”

The U.S. economy can be characterized as somewhat resilient over the past few years. The aforementioned Bloomberg survey puts the recent consensus forecast for 2012 U.S. real GDP growth at 2.2% compared with a projection of 3.0% fifteen months ago. Second quarter growth was recently updated to be 1.3%, behind the 2.0% report for the first quarter. Among the major developed countries, the U.S. has demonstrated the most improvement since the 2008-2009 recession. Indeed, U.S. GDP is approximately 10% higher than the first quarter of 2008, its pre-recession peak.

While job gains have been skittish and the unemployment rate only recently dipped below 8.0%, two key cyclical sectors of the economy are showing signs of better health. Sales of light vehicles are at an annual rate of nearly 15 million units, at least four million more than 2009’s low of 10 million. Housing, which has only been contributing about half as much to GDP as its 30-year average, appears to be mending. In September, sales of existing single family homes were up 40% from the 2010 bottom. Housing starts, while still below their 2006 peak, are up more than 50% from their 2009 bottom. Home prices, as measured by the S&P/Case-Shiller Index of twenty major metropolitan areas, gained 1.6% in July from June. The Index, still 30% below its 2006 peak, rose in all twenty areas. According to *The Bank Credit Analyst* (August 2012 – Vol. 64 – No. 2), “there is no post-war precedent for a recession to occur when the cyclical sectors of the economy are as beaten down as they currently are.” An index of U.S. consumer confidence just reached its highest level since September 2007.

Investors should brace themselves for more frightening headlines over the so-called U.S. “fiscal cliff.” (See Table 2)

Unless Congress passes new legislation by year end, automatic spending cuts and tax increases are set to begin in January 2013. According to an August 2012 report by the Congressional Budget Office, the spending drag could cause 2013 GDP to contract by 0.5% and unemployment to rise to 9.0%. As the deadline approaches, we may see announcements of layoffs from suppliers to the U.S. defense industry, which has been targeted to bear most of the automatic spending cuts.

### Earnings Matter Most

Corporations have an amazing ability to adapt to change and continue growing. Apple is just one of many examples. Over time, earnings growth for U.S. corporations has trended at a fairly consistent pace of 5.0%-6.0% annually (See Chart 1).

The stock market has retrenched during periods of recession, but has survived major worries, such as World Wars, the Cuban Missile Crisis, the attacks of 9/11, etc. Indeed, these events appear as mere blips on a long-term price chart.

The biggest market moves are engendered when earnings rise or fall precipitously. Companies in the S&P 500 Index are expected to report an earnings increase of approximately 6.0%-7.0% for 2012 over 2011, some 20% above their previous peak level in 2007. Perhaps this explains why the U.S. stock market was one of only four, among the 30 country markets tracked in a *New York Times* article (August 25, 2012), trading above the global market peak of October 31, 2007. According to the *Barclays U.S. Earnings Scorecard* (August 17, 2012), 68% of S&P 500 companies exceeded second quarter estimates on the earnings line, but only 40% surpassed expectations on the revenue line. The consensus forecast for 2013 earnings amounts to a gain of over 10%. This appears high, in light of current economic trends and the fact that corporate profit margins are already lofty. “There’s been an enormous amount of academic research on the link between changes in earnings and changes in stock prices. And the consensus is that while the long-run correlation is high, over shorter-term periods—say, a quarter

continued on page 6

Table 2. References to the phrase “fiscal cliff” in 2012:

	Calendar 2012 To Date								
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
WSJ Print Edition	3	0	7	4	14	14	18	33	21
Digital Media <sup>1</sup>	7	5	21	12	60	89	156	237	356

<sup>1</sup> Includes: WSJ.com, Barron’s, SmartMoney, DJ Newswires, MarketWatch, All Things Digital

# Highlights of the Massachusetts Uniform Trust Code

By Robert C. Pasciuto, Vice President and Trust Officer, 617-441-1506

For those of you who are regular readers of the TrustLetter, you may recall an article in the Spring 2010 issue discussing a trustee's duty to inform under the Massachusetts Uniform Probate Code ("MUPC"). After several delays, the MUPC became effective at the end of March 2012. Little more than three months later, however, the trust provisions of the MUPC were superseded when Massachusetts enacted its version of the Uniform Trust Code, which became law on **July 8, 2012**.

The Massachusetts Uniform Trust Code ("MUTC") makes a number of changes to long standing trust law in Massachusetts. Although a few changes are similar to the MUPC, the MUTC goes well beyond that law in its scope. The MUTC applies to all trusts administered in Massachusetts created before and after the law's enactment (although there are several exceptions to that rule). The provisions of the MUTC are mostly rules of default. A trust can be written to override many of the MUTC's provisions. However, there are some rights and duties that are so integral to the administration of a trust, that they cannot be modified. For example, the trust instrument cannot be written to relieve a trustee of its duty to act in good faith and in the interest of the beneficiaries. Similarly the right of a court to exercise its oversight powers over a trust cannot be restricted. With those ground rules in mind, what follows are a few of the new law's highlights.

**Duty to Inform Beneficiaries:** The MUTC confirms a trustee's responsibility to keep the beneficiaries informed about the administration of the trust. However, it also adds a few new wrinkles. The law defines a class of beneficiaries known as "qualified beneficiaries". Qualified beneficiaries are those beneficiaries currently entitled to receive distributions from the trust and those who would be entitled to the distribution of the trust property if the trust then terminated. For example, if a trust provided for income to be paid solely to the settlor's son during the son's life, and then distribute at the son's death to his children, both the son and the grandchildren are considered qualified beneficiaries at any time after the settlor's death even though the grandchildren have no present interest in the trust, and could possibly predecease their father. Qualified beneficiaries are entitled to

information about the administration of a trust. A trustee must provide an account of trust activity at least annually to those qualified beneficiaries who request it. To ensure that a qualified beneficiary has adequate notice of the trust, the MUTC requires a trustee to notify all qualified beneficiaries in writing of the trustee's name and address within thirty days after its acceptance of the trust or the trust becoming irrevocable.

**Presumption of Revocability:** For trusts created on or after July 8, 2012, the settlor has the right to revoke the trust unless the trust instrument expressly states that it is irrevocable. This reverses the prior rule in Massachusetts.

**Majority Action by Trustees:** Where there is more than one trustee, the trustees may act upon majority decision. The rule applies if the trustees cannot reach a unanimous decision implying that all of the trustees must confer and attempt to reach an agreement before the majority rule can be invoked. This provision applies only to trusts created on or after July 8, 2012. Non-charitable trusts executed before that date continue to follow the old rule requiring trustees to act unanimously unless otherwise provided in the trust instrument.

**Co-Trustee Liability:** A trustee who does not join in the action of a co-trustee generally is not liable for the actions of the co-trustee. However, that trustee can be held liable if he or she fails to exercise reasonable care in preventing a co-trustee from committing a breach of trust, and compelling a co-trustee to redress a breach of trust.

**Uneconomic Trusts:** The MUTC gives the trustee discretion, without prior court approval, to terminate a trust with a value of less than \$200,000 if the trustee determines the value of the trust is insufficient to justify the cost of administration. Before terminating the trust, the trustee must give notice of its intention to do so to all of the qualified beneficiaries. Upon termination, the trust property shall be distributed in a manner consistent with the purpose of the trust. This may result in the trust being distributed among several beneficiaries including those with future as well as present interests. The MUTC also provides that a court may terminate or modify an uneconomic trust.

continued on page 5

## Highlights of the Massachusetts Uniform Trust Code *(continued)*

**Modification and Termination of Trusts:** A court has the power to modify or terminate a non charitable trust regardless of whether it is uneconomical if the settlor and all of the beneficiaries consent. This is true even if the result is inconsistent with a material purpose of the trust. A court may also modify or terminate a non charitable trust with the consent of all of the beneficiaries if such action is not inconsistent with a material purpose of the trust. Finally, a court may modify or terminate a non charitable trust with the consent of less than all of the beneficiaries if the court is satisfied that the trust could have been modified with the consent of all of the beneficiaries, and the interests of the non consenting beneficiaries are adequately protected.

**Purpose Trusts:** A formal requirement for a valid trust (other than a charitable trust) under prior law was that the trust must have an identifiable beneficiary or class of beneficiaries. The MUTC relaxes this requirement and allows for the creation of a non charitable trust for a purpose even though an ascertainable beneficiary is not identified. The purpose may be set forth in the trust instrument or may be selected by the trustee so long as it is a valid purpose. In the Winter 2011 TrustLetter, we gave an example of a purpose trust where a settlor wants to create a trust to maintain a family estate but does not want to specifically name individual family members as beneficiaries.

**Virtual Representation:** Absent a conflict of interest, persons who lack legal capacity may have their interests represented with respect to an issue or a dispute involving a trust. For example, a parent may represent a minor or unborn child. Guardians and conservators can represent wards and protected persons. Trustees and personal representatives can represent trust beneficiaries and persons interested in an estate. This provision of the MUTC should reduce the instances in which a court will have to appoint a guardian ad litem to represent the interests of minors and unascertainable beneficiaries.

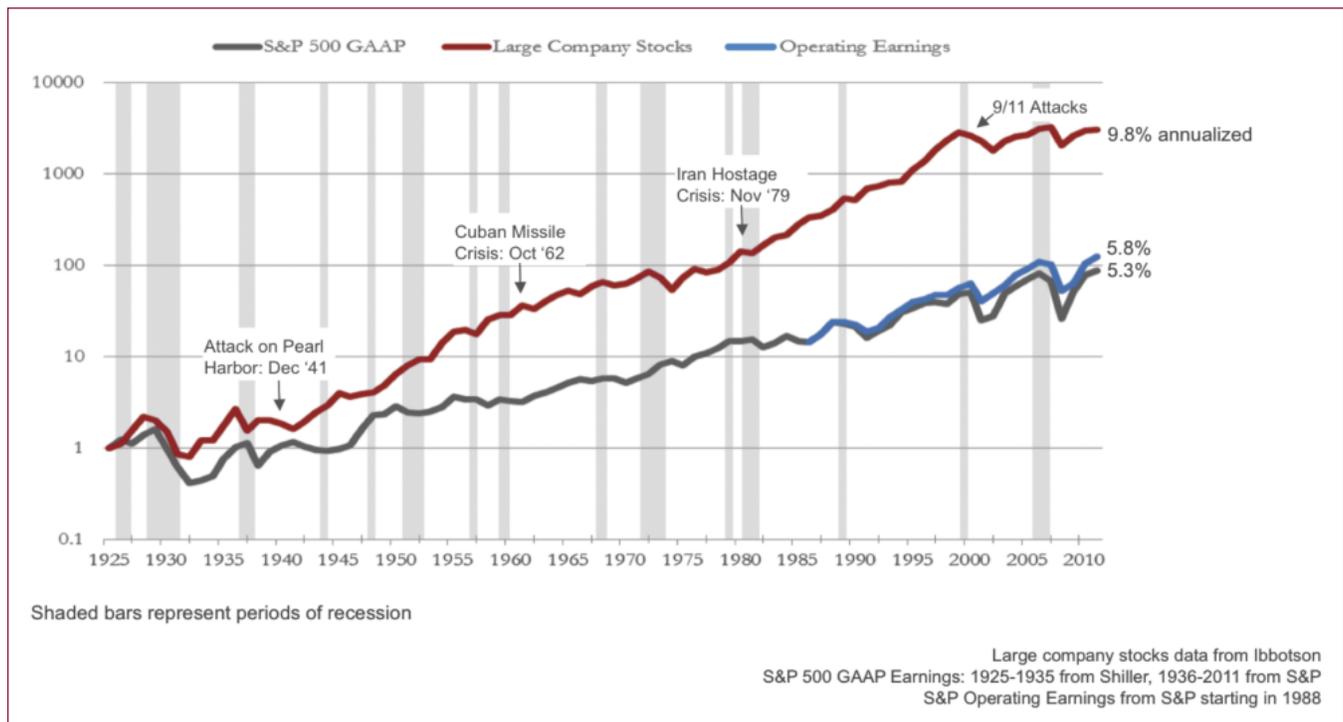
**Non Judicial Settlement Agreements:** One matter in which virtual representation may prove to be useful is in the execution of non judicial settlement agreements. New to trust law in Massachusetts, such agreements allow trustees and beneficiaries to resolve trust related issues without court intervention. Matters that may be resolved by non judicial settlement agreements include: the interpretation and construction of a trust's terms; the approval of a trustee's accounting; the resignation or appointment of a trustee; the transfer of a trust's principal place of administration, and the liability of a trustee. Non judicial settlement agreements may not, however, violate a material purpose of the trust.

**Power to Direct a Trustee:** A person other than the settlor may be given the power to direct certain actions of the trustee. Such individuals are often referred to as "trust protectors." Such a person is presumed to be a fiduciary and must act in good faith. Although the trust document states that the trustee is to follow the trust protector's direction, it is still incumbent upon the trustee to ensure that the directive is proper. A trustee should not follow instructions where they are manifestly contrary to the terms of the trust, or where the trustee knows they would constitute a serious breach of a fiduciary duty that the trust protector owes to the beneficiaries.

Massachusetts is one of a number of states that have adopted the Uniform Trust Code. Although the word "Uniform" appears in the title of the code, each state enacts its own version of the law. The Winter 2011 issue of the TrustLetter discussed the New Hampshire version of the code in some detail. Trusts created under New Hampshire law can run in perpetuity (dynasty trusts) or may protect the settlor's assets from creditors (asset protection trusts). Such trusts are not currently recognized in Massachusetts. In New Hampshire, the duties of administration can be divided among co-trustees, or a trustee may be excluded from a particular function. With offices in both Massachusetts and New Hampshire staffed by trust professionals, we at Cambridge Trust Company can work with you and your attorney to establish and administer your trust under the laws of the state best suited to your needs.

# Sinking Into Optimism *(continued from page 3)*

**Chart 1: Large Company Stocks and S&P 500 Earnings**



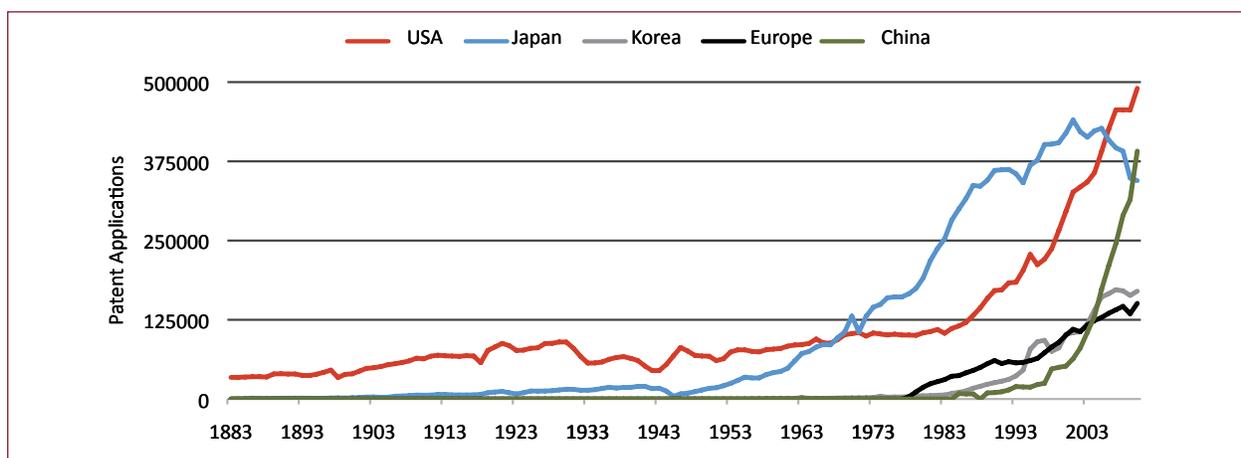
or a year—the relationship is weak, if there is any at all.” (*T.Rowe Price Report*, Issue No. 115 Spring 2012). Chances are, the stock market will survive whatever befalls Greece or Spain as well as our own budget challenges, as long as earnings progress.

In regard to the outlook for sustaining the long-term earnings record of major corporations, some observations on the world’s two largest economies provide encouragement. The

pace of innovation in the U.S. and China stands out among major economies. The growth in the number of patent applications filed and granted in the U.S. and China has more than tripled in the past 30 years (See Chart 2).

Labor productivity growth in the U.S. has been holding at a modest 1.0% or so since 2006, but expanding by more than 8.0% annually in China. The U.S. has a demographic advantage because its working age population (ages 15-64) is

**Chart 2: Trend in Patent Applications**



Source: WIPO Statistics Database, October 2011

continued on page 7

## Sinking Into Optimism *(continued)*

projected to increase at a rate of 1.0%-1.5% annually over the next 25 years; China's is projected to begin a long-term decline commencing before 2020 ("Investing in U.S. Manufacturing Renaissance," *ISI International Strategy & Investment*, March 5, 2012). In the 2011 listing of the top 100 global brands by the consultancy firm Interbrand, U.S. firms occupied all top ten spots. Although China did not make this list of 100, a similar ranking by *Marketing Week* (May 24, 2012) included three Chinese companies—China Mobile, China Construction Bank and Baidu—among the top 25. Thus long-term earnings of well-run companies in these two economies should continue.

### The Only Certainty is Change

Lately, I have been thinking about how events can unfold differently from our initial perception. I don't know if they actually change or we just grow to view them differently than we thought we would view them. Is our ability to predict how we will feel in the future simply flawed? In 1861, the Confederates fired on Fort Sumter in South Carolina after President Lincoln had ordered provisions sent to it. The Unionists fired back. A few thousand shots were fired in total. The only fatality was a mule (John Keegan, "The American Civil War"). By 1865, there were over 600,000 American lives lost, more than both World Wars combined.

In the Fall 2006 issue of the *TrustLetter*, I wrote about the beloved purple martins that had been returning to my home in New Hampshire to nest each spring. "They glide, dart and soar high in the sky," beautiful to watch as they feed on insects. Not content to leave well enough alone, I erected a second birdhouse thinking I would attract even more. To my dismay, when the martins returned the following spring they refused both houses. A squirrel had claimed their original home and the martins wanted none of it. Like a fool, I unintentionally knocked the original house down trying to shake the squirrel out. Undaunted, I moved the second house back to the original location and painted it white to make the inside cooler. Although the martin population has been declining in the Northeast, they are flourishing again in my birdhouse. (I hope I am not mistaking them for sparrows or starlings; I believe they are martins.) A few years ago I did not think I would ever be able to watch them again.

I was looking for an apt expression that would connect investors, corporations, martins, and the average person striving for happiness, and was greeted with this Bloomberg quote on October 17, 2012, "Knowledge of what is possible is the beginning of happiness." (George Santayana). Do you think it is possible to have a better world in a few years?

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## Cambridge Trust Profile

David G. Strachan, Jr.

*Senior Vice President and Trust Officer*

Cambridge Trust Company announced the promotion of David G. Strachan, Jr. to Senior Vice President and Trust Officer in August 2012. David has been with Cambridge Trust Company since 1996 and now also serves as the Head of Trust Administration in the Wealth Management Department.

David is a member of the Boston Estate Planning Council and Treasurer of the Essex County Estate Planning Council. He is also President of the Wellmet Project, Inc., a newly elected Board Member of the Cambridge Center for Adult Education, both in Cambridge, MA and is Chairman of the Topsfield (MA) Commissioners of Trust Funds.

He received a B.A. degree in History from St. Lawrence University in Canton, NY. He is also a graduate of the American Bankers Association's National Graduate Trust School and Private Wealth Management School, and Boston University's Certified Financial Planning Program. The Certified Trust and Financial Advisor (CTFA) designation was earned by David in 1995.

David lives in Topsfield with his wife, Susan, and their three children.



# Cambridge TrustLetter

Fall 2012

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## Cambridge TrustLetter *Editor – Laura C. McGregor*

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