

Risk or Opportunity

By James F. Spencer, CFA, Senior Vice President and Chief Investment Officer, 617-441-1505

In this edition of the TrustLetter, the investment article by Eric Warasta discusses the relative attractiveness of dividend-paying equities as one of the opportunities created by the recent market volatility and the fear and uncertainty left in its wake. These dividend-paying equities are often represented by larger, multinational companies with strong balance sheets. The non-financial companies in the S&P 500 Index currently hold cash balances equal to approximately 12% of their market capitalization, according to David Bianco, chief U.S. strategist at Bank America Merrill Lynch (as reported in Barron's, September 5, 2011, page 28).

U. S. real GDP expanded at an annual rate of less than 1.0% in this year's first half (0.4% and 1.3% in the first and second quarters respectively). Recent economic data, such as an Institute for Supply Management index measuring manufacturing activity, have pointed to further weakness. The August reading of that index in the U.S. was 50.6, barely above the 50.0 mark delineating expansion from contraction, and compares to a reading of over 60.0 earlier in the year. The consensus forecast for 2011 U.S. real GDP growth among economists polled by Bloomberg has dropped to about 1.7%, approximately one-half the rate forecasted at the start of the year (see chart on next page). In its August 27, 2011 publication, *The Economist* referenced research by a Federal Reserve staff member suggesting that, since 1978, the economy has often fallen into recession following a quarter of less than 1.0% real GDP growth (*The Economist*, August 27, 2011, page 25).

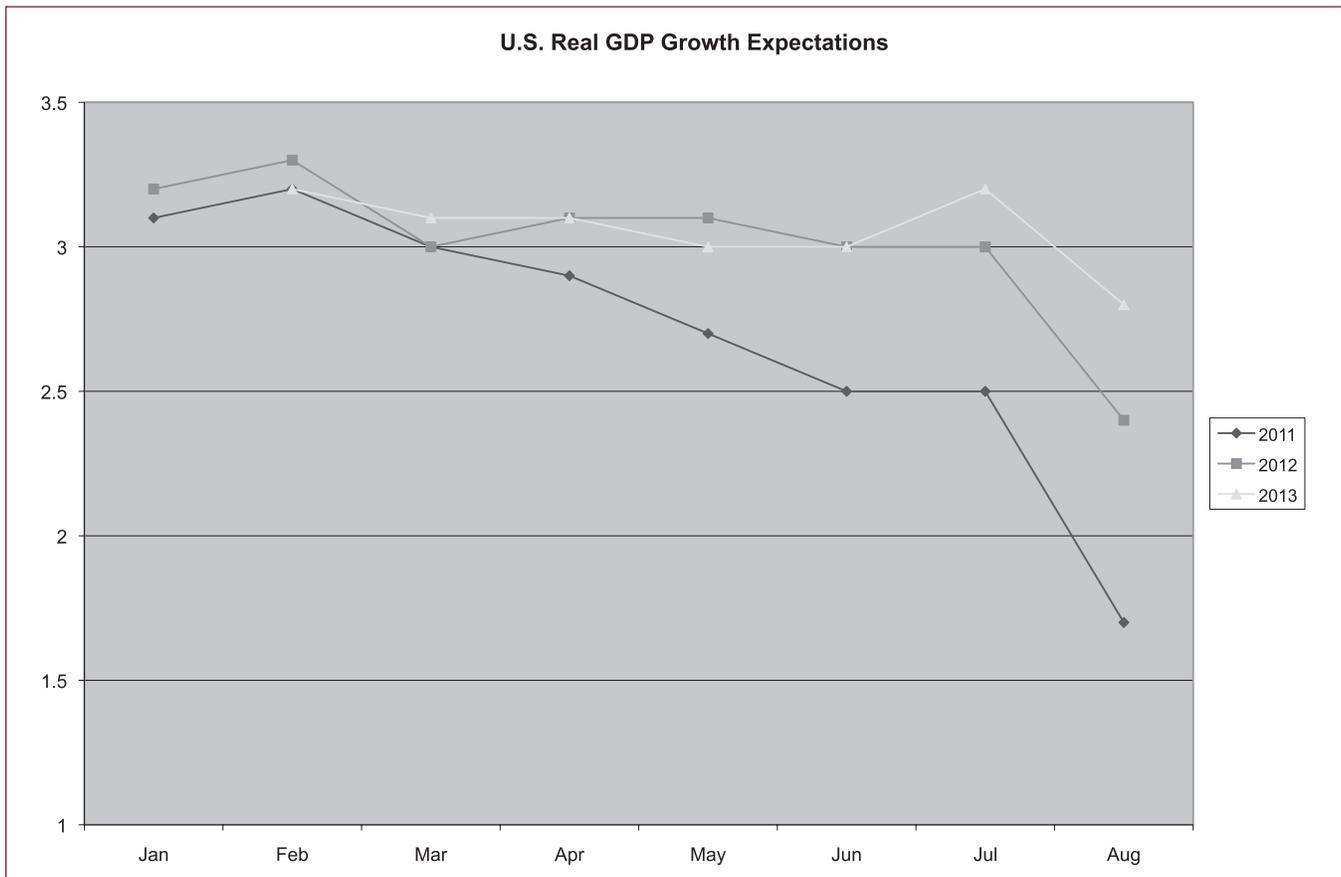
The situation in Europe is even worse, with countries such as Greece on the verge of default and bank capital ratios threatened by the potential mark-down of sovereign debt holdings; the interest rate on one-year Greek debt recently crossed 80.0%. (For more background on economic and market trends, see our recent Thought Series® article, "Coping with Volatility," located on our website.)

The type of abrupt market volatility witnessed in early August when, for four consecutive days commencing August 8, the market gyrated by more than 4.0% in each direction, is the most terrifying for investors and consumers. A consumer sentiment index compiled by the University of Michigan reached a 30-year low in August 2011. It is times such as these when we are most susceptible to the predictions of experts who, if overconfident from past successful predictions, are often wrong. In his book *Future Babble, Why Expert Predictions Are Next To Worthless, And You Can Do Better*, page 141, author Dan Gardner comments on our basic need for certainty: "As strange as it sounds, we want to believe the expert predicting a dark future is exactly right, because knowing that the future will be dark is less tormenting than suspecting it."

Uncertainty and volatility beget fear, which can interfere with our analysis of potential investment opportunities. According to psychologist, Madeleine L. Van Hecke, "our thinking processes are disrupted when we are under emotional stress, so we sometimes fail to think when we're under a deadline or in a crisis situation." (*Blind Spots, Why*

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Source: Bloomberg, median forecast of economists, August 2011

Smart People Do Dumb Things, page 38) BCA Research dissected the causes of the sub-par performance of the U.S. economy and estimated that, “temporary factors, namely the earthquake in Japan and higher commodity prices, shaved around 1.5% off growth in 2011H1,...” (*The Bank Credit Analyst*, September 2011-Vo. 63-No. 3, page 32) This perspective could suggest some lift in growth later this year, netting out the impact of Hurricane Irene.

One expert perhaps worth a listen is Professor Robert J. Shiller – not in the overconfident camp, according to author Gardner. In a September 4, 2011 article in the *New York Times*, Professor Shiller worries that market investors are trapped in a crazy game of “trying to guess whether other investors are thinking that yet others are thinking that the stock market is ‘dangerous’, or whether it is instead a great time to invest...And because anxiety is running high, investors make quick, sometimes impulsive, responses to relatively minor events.”

Many of the events plaguing the market are more than minor. Nevertheless, our view is that today’s investment environment is creating long-term opportunities, increasingly apparent in the dividend-paying stocks of large multinational companies. Our analysis of Microsoft, for example, would indicate that the stock price is presently discounting between no growth and an actual significant decline in growth – out to infinity – in its free cash flow. Although the company’s core Windows franchise is certainly vulnerable to market penetration from tablets, the stock price appears to reflect an overly pessimistic outlook. Over the past five years, Microsoft’s earnings and dividends have increased at annual rates of 18% and 15% respectively. The case for dividend-paying stocks that have the wherewithal to increase their payouts is reviewed in Eric Warasta’s article.

Opportunity in a Low-Interest-Rate World

By Eric G. Warasta, CFA, Assistant Vice President, 617-441-1490

In its review of the 1981 “political-romantic thriller” *Rollover*, *Variety* magazine found the film “fundamentally disappointing.”¹ The plot revolved around an heiress (Jane Fonda) and a banker (Kris Kristofferson) who fall in love while becoming ensnared in a web of international monetary intrigue. Many of the themes explored in the film will sound familiar to today’s investors – the collapse of a major bank, a loss of faith in paper currencies, rising gold prices, global political turmoil, and economic uncertainty. It should come as no surprise that the movie was produced at the conclusion of a turbulent decade when the U.S. economy experienced extended periods of high unemployment and rapid inflation. We disagree fundamentally with *Rollover’s* rather dark conclusions. Although not recommending the film, which, incidentally, lacked commercial or critical success, we can recommend a framework for investing in turbulent times – specifically, we continue to find dividend-paying equities attractive.

As was the case in the early 1980s, today’s environment marks a period of attractive equity valuations, particularly dividend-paying stocks. This article discusses the philosophy and construction of our Equity Income Matrix, used as an equity model for selected portfolios. The Equity Income Matrix is designed to be a comprehensive equity portfolio, offering exposure to stocks with less volatility and more current income, while still capturing the long-term capital

appreciation and inflation protection that equities provide. (Another equity model that we have developed is the Total Return Equity Matrix, which focuses on companies with expected superior earnings growth relative to the broader market.) Some companies on our Stock List satisfy the objectives of both Matrix portfolios and are therefore included in both models.

Equity Valuations are Reasonably Attractive

We think that equity valuations are currently attractive, both in absolute terms and relative to fixed income securities. The S&P 500 Index is currently trading one standard deviation below its average P/E ratio since 1960 and, excluding a brief period in early 2009, is the cheapest the S&P 500 has been on this metric since the 1980s (see chart below). In addition, comparisons with fixed income investments remain attractive, with the yield on the S&P 500 nearly equal to the yield on 10-year U.S. Treasury bonds. Many stocks with consistently growing dividends are at the top of our list of attractive valuations. Historically, these stocks have exhibited less volatility than the broader market (as represented by the S&P 500). In addition, larger capitalization multinationals – a group that has been out of favor for some time – constitute a large portion of the universe of dividend-paying stocks. The largest stocks have lagged the market since the late 1990s and may be due for a period of stronger relative performance.²



Source: Cambridge Trust Company, Bloomberg.

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Helping Your Spouse and Family After Your Death

By Julie A. Alix, Vice President and Trust Officer, 617-441-1537

Note from the Editor: We have updated and are re-publishing this article from our Fall 2005 TrustLetter because of its popularity and importance. We welcome your questions and comments.

Do your spouse and family know:

- your burial and funeral wishes?
- the location of your will?
- the location of your safe deposit box(es) and key(s)?
- the location of any securities or the accounts that hold them?
- your bank accounts, mutual funds, life insurance policies and any other assets?
- the location of titles, real estate deeds, and income tax records?
- your regular household and personal bills and their frequency for payment?
- how to reach your estate planning attorney, trust officer, accountant, and other advisors?

When you pass away, it will be a difficult time for your spouse and family, used broadly to include your children, partner or advisers. For purposes of this article, we will refer to your spouse. There are some steps that you can take now to make it much easier on your loved ones and those whom you trust and are counting on to perform significant functions after your death. Valuable information about your assets, benefits, income and wishes should be organized and accessible to your spouse and executor.

Your information should be collected in an Estate Notebook, with backup to a secure electronic storage device. Keep the notebook or electronic storage device in a mutually agreed-upon and secure place. The function of the notebook is to provide your spouse and your executor with burial or funeral guidance, a list of benefits to be claimed, the location of assets, the contact information for your advisers, and the location of important records. It can protect your estate and assist your spouse and executor in settling your estate, saving considerable time and expense and reducing anxieties.

Basic Data

At a minimum, you should have a document with the essential information needed for a death certificate, including your social security number, date of birth, place of birth, including city or town, state and country; full name of your father and full name of your mother, with maiden name. The

birthplace of your parents is also good information to provide. You should include a copy of your birth certificate. Also record the date of your marriage(s) and any subsequent divorce, including a copy of your marriage certificate and the location of information about any divorce decree.

Include a list of the names, addresses (email), and telephone numbers of all of your advisers, including your estate-planning attorney, trust officer, accountant, investment managers and insurance agents.

Finally, for ongoing household management, a separate list of companies or individuals you employ for plumbing, electrical work, fuel delivery, furnace and chimney cleaning, carpentry and repairs, housekeeping, landscaping and garden maintenance can be extremely helpful. A separate list for vacation homes in another locale should be included. Contact telephone numbers and email addresses should be included on the lists.

Your Will

When you die, the most important document that your spouse must locate is your original will, which will be used by your attorney to begin the process of probating your estate. It may be held for safekeeping at your attorney's office or in your safe deposit box. When Cambridge Trust is named executor, we often hold the will in our own Wealth Management vault for safekeeping and ready access after death. Include a copy of your will and any codicils in your Estate notebook, and write on the copy of each the location of the original documents.

Funeral and Burial Planning

No one wants to think about his or her own mortality, but it is much easier to contemplate funeral and burial wishes when you are mentally strong and physically healthy, not facing difficult medical situations. Pre-planning your own funeral is difficult, but pre-planning can relieve your spouse and family of the necessity of decision-making at the most stressful time. You may leave instructions relating to your burial and funeral, to be carried out at your death, or you can meet with your local funeral director to prearrange and prepay your funeral services.

Helping Your Spouse and Family After Your Death *(continued)*

Provide an outline of your significant life events and accomplishments for the celebrant for your services and to assist your family in preparing an obituary. Your spouse will be comforted knowing that the arrangements reflect your wishes and relieved to know that he or she does not have to make these decisions or remember things at an emotionally difficult time.

At a minimum, you should include in your notebook the location of your cemetery plot and the location of the deed for that plot. A copy of the deed and any plot plan will be useful. If you do not own a cemetery plot, specify where you wish to be buried and whether you wish to be cremated or not. Provide instructions about the place of the service and the celebrant desired. If you do decide to make pre-arrangements with a funeral home, the name, address and telephone number of the funeral home should be placed in your notebook.

Life Insurance and Annuities

Details on all annuities and life insurance policies, with policy numbers and Beneficiary Designations, should be provided, along with a copy of each and the location of the originals. Include the most recent annual statement for each in the notebook.

Securities and Other Investment Assets

A list and copies of all brokerage, bank, mutual fund and investment accounts, as well as any limited partnerships, are essential. For IRA or IRA Rollover accounts, provide a copy of the current Beneficiary Designation form, indicating primary and, if appropriate, contingent beneficiaries, as well as whether you currently have been receiving any distributions, how much and at what intervals. In addition, the notebook (and your accountant) should have a record of any federally tax-deductible and non-deductible contributions that you made to your IRA, so that taxability can be ascertained when distributions are made.

If you hold any stock certificates in physical form, provide the description and where they are being held (e.g. safe deposit box at specified bank and branch location). If you hold assets in book entry form at the transfer agent, include the most recent annual statement in the notebook.

Benefits

To collect benefits, your spouse will need to know what they are and whom to contact. Benefits paid by the Social Security Administration, Veteran's Administration, and current or former employers are the first that come to mind.

Social Security Benefits

If you paid into social security, your spouse or dependent children may be eligible for a Death Benefit (currently \$255 for burial expenses) and for Survivor Benefits, which vary depending on the age and relationship of the survivors. You can find useful information about these benefits on the internet at www.socialsecurity.gov. For some benefits, you may even apply online. To file for the Death Benefit, you may call 1-800-772-1213.

To inquire about benefits, your spouse will need your social security number and should know whether you applied for or were receiving social security retirement benefits, Medicare or Supplemental Security (SSI).

Veterans Benefits

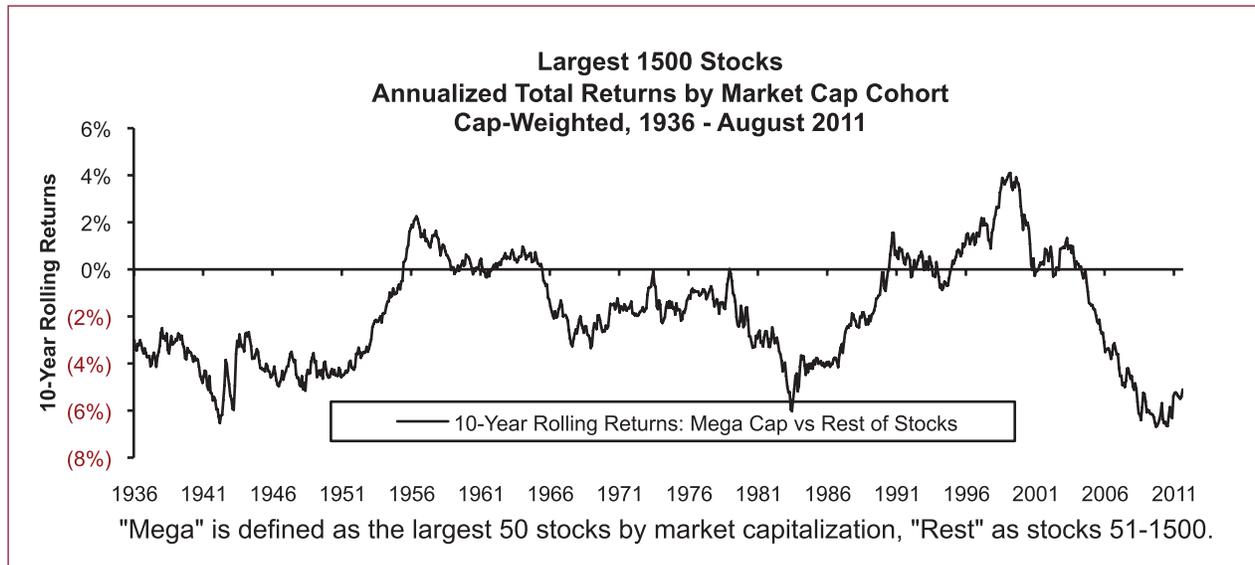
If you are a veteran with an honorable discharge, your spouse may be entitled to funds for funeral and burial costs. Burial in a national cemetery is free. Veterans are also eligible for a grave marker and a flag. If you are veteran, it would be helpful for your spouse to know your dates of service and date of discharge. If you have a copy of your discharge papers, include them in the notebook. For more information, you may contact the Department of Veterans Affairs at 1-800-827-1000, or visit the website www.va.gov.

Retirement Benefits

Many employers provide life, health, and accident insurance, as well as retirement benefits in the form of a pension, 401(k) Plan, Employer Stock Ownership Plan (ESOP), and stock options. Be sure to keep a list of all plans and benefits, with a description and a copy of any Beneficiary Designation forms. Also include contact information for your current employer and all past employers from whom you are due benefits. Since many companies have merged or been acquired, it is very important to keep the list updated. It is helpful to keep the most current annual statement from any retirement plans in your notebook, along with name of the beneficiary.

Trusts

If you ever established a trust or are the beneficiary of a trust, provide the location of the original instrument and amendments for your own trust and include a copy of those documents in the notebook. If you have a copy of trusts of which you are a beneficiary, include those copies in the notebook as well. An annual or current statement for each trust account is useful. Include for each trust the name of the trustee (which may be an institution or individual), name of



Source: Bernstein Research.

Identifying Sustainable Dividend Growth

Sources of strong earnings and dividend growth are many and varied. However, at the core, the companies that we select for the Equity Income Matrix tend to exhibit sustainable, defensible business models with high barriers to entry and one or more of the following characteristics: strong secular growth trends, flexibility to raise prices to offset inflation, increased sales to emerging economies, unique industry characteristics, or simply a renewed emphasis on returning cash to shareholders. Illustrative examples include: Union Pacific and Praxair, which have high barriers to entry; IBM and Schlumberger, which are increasing very modest payout ratios; McCormick, Coca-Cola, and Pepsi with high market share and a good degree of pricing power; and Travelers, which participates in a largely overcapitalized property and casualty insurance industry. Many companies in our Equity Income Matrix have increased their dividends in 2011—Microsoft (+25%), Target (+20%), Schlumberger (+19%), Travelers (+14%), Praxair (+11%), Procter & Gamble (+9%), ExxonMobil (+7%), and Pepsi (+7%).

For much of the past twenty years, dividends were seen as the purview of mature companies and slow-growth enterprises such as electric utilities. Investors regarded dividend payers with a skeptical eye – after all, how will a company grow if it is returning its excess capital to shareholders, rather than investing in new projects? We believe that earnings growth and dividend income are not mutually exclusive, and our approach seeks to identify companies with rising earnings and a commitment to growing the dividend.

The seemingly innocuous statement that investors should seek robust earnings growth from equity income investments is often met with surprise. Yet, earnings are the raw material from which dividend growth is possible. A commitment to a growing dividend can play a role in protecting shareholders against potentially negative outcomes associated with a buildup of large cash balances: self-inflicted damage (large mergers, share repurchases at high prices); management complacency in the face of technological change and/or competitive threats; or simply sub-par return on capital (excess cash on the balance sheet). In our view, earnings growth provides the fundamental basis for equity income investing. We believe that, over time, this approach should provide a stronger growth profile and better downside protection (against a potential decline in earnings) than a strategy that owns only the highest-yielding securities.

As evidence that dividend growth and earnings growth are not mutually exclusive, a number of companies in the Equity Income Matrix portfolio posted strong earnings and dividend growth over the past five years, despite an unusually deep and prolonged recession (see table on adjacent page). In fact, there are fourteen companies in our Equity Income Matrix portfolio that delivered annualized earnings growth in excess of 10.0% over the past five years, while seven of those fourteen delivered annualized earnings growth in excess of 15.0%. In addition, thirteen of the fourteen companies mentioned above grew their dividends at least 9.0% annually over the past five years. In comparison, the S&P 500 experienced annualized earnings and dividend growth of

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1.8% and 1.6% respectively over the same period. The unfavorable comparisons for the S&P 500 are largely the result of reported losses and dividend reductions by banks and other financial companies. That dividends should rise more slowly than earnings is somewhat intuitive as earnings tend to be more volatile than dividends; dividends are viewed as long-term commitments that companies are often reluctant to cut.

opinion piece in the August 22, 2011 *Wall Street Journal*, “Per share dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which handily beat the average rate of inflation of 4% during the period. In fact, dividend growth has beat inflation both during the low inflation periods of the 1960s, 1990s, and 2000s, and the high inflation periods of the 1970s and early 1980s.” Siegel and Schwartz further point out that the “entire decline in

	Company	Dividend		Annualized Growth Rate, 5 Years	
		Payout Ratio	Yield	Earnings	Dividends
1	BlackRock Inc.	38%	3.74%	24.7%	27.2%
2	Union Pacific Corp.	24%	2.29%	23.5%	16.9%
3	Coca-Cola Co.	35%	2.71%	20.0%	9.5%
4	International Business Machines Corp.	22%	1.73%	18.7%	26.2%
5	Travelers Cos. Inc.	21%	3.40%	18.0%	9.2%
6	Microsoft Corp.	24%	3.08%	17.6%	14.9%
7	NextEra Energy Inc	42%	4.01%	15.6%	7.1%
8	Schlumberger Ltd.	25%	1.53%	13.7%	14.9%
9	Ecolab Inc.	29%	1.39%	12.7%	12.0%
10	McCormick & Co. Inc.	38%	2.46%	12.1%	10.2%
11	Johnson Controls Inc.	24%	2.29%	12.1%	9.3%
12	Praxair Inc.	47%	2.06%	11.6%	20.1%
13	JPMorgan Chase & Co.	20%	3.30%	10.7%	-31.8%
14	PepsiCo Inc.	48%	3.39%	10.3%	13.4%

Source: FactSet

One measure of dividend sustainability is the dividend payout ratio, which divides the current dividend by the level earnings. Dividend payout ratios remain modest and, in many cases, below historical levels. For example, the S&P 500 dividend payout ratio is currently 28%, well below the average of 52% since 1960.³ This ratio indicates room for further increases in the dividend and/or a substantial cushion to continue paying the dividend in times of earnings duress. Many income-oriented equity investors focus on understanding if the current payout is sustainable. We try to set a higher bar – our research seeks to identify currently attractive payouts that can grow over time. Not surprisingly then, the weighted average payout ratio for our Equity Income Matrix portfolio is just 36%.

Dividends Have Been a Stable Source of Income

As Jeremy Siegel and Jeremy Schwartz point out in their

dividends of U.S. stocks during the [2007-2009] recession was due to the fall of the financial sector. The sum of the dividends paid by firms in the other nine sectors of the U.S. equity markets was actually higher in 2009—at the bottom of the worst recession and bear market in the past 75 years—than it was in 2007, when stocks and the economy were at their peak.”

Dividend sustainability has been further enhanced by the benefits of global diversification. Many of the companies represented in the Equity Income Matrix portfolio derive a large portion of their revenue from outside the United States. They provide additional diversification and stability, as large U.S.-domiciled companies are major participants in global GDP growth, currently being led by emerging markets. Companies such as 3M (66% non-U.S. revenue, almost half of which is emerging markets) and IBM (55% non-U.S. revenue) derive a significant portion of revenue from emerging economies with significantly higher growth rates

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the Trust Officer or other trustee representative with whom you communicate and that person's address (email) and telephone number.

Real Estate

Provide descriptions of all real estate holdings, residential and commercial, along with copies of the deeds and a copy of a real estate tax bill. If the location is difficult or unclear, include directions. For rental real estate, list the location of the property, the name(s) of the current tenants, and the rent amount, due dates and method of payment. Put copies of current leases in the notebook. If there is a property manager or someone else assisting you in the oversight of the property, provide the name of the firm or individual, address and telephone number. If you are managing the property yourself, the notebook should include a list of any companies or individuals whom you typically use for maintenance.

Tangible Personal Property

Appraisals of any valuable personal property or collectibles, along with the location of the property and the contact information for any experts with whom you have consulted, should be placed in the notebook. Photographs of valuable items, particularly those listed on a fine arts schedule of your homeowners policy, are useful. Provide the location of any titles, such as for your automobiles and boat.

Loans

If anyone owes you money, indicate the details: name and contact information for borrower, amount of loan, and your expectations regarding payment of interest and principal. Include copies of any promissory, demand, or mortgage notes, and indicate where the originals are held.

Debts

Provide information about your debts, such as credit cards, outstanding mortgages, or loans made to you. Provide the amount, payee, account number, and schedule for payments, as well as a copy of a recent statement. If you have any loans that were paid off in full, you may want to include documentation that states that such payoff was made, or include the original note so marked.

Insurance Other than Life Insurance

All types of insurance, such as property, liability, personal health, automobile, accident, credit card and malpractice, should be listed, with the name of the insurance company, policy number, location of the policies, and contact

information for each insurance agent responsible for your coverage. This information will help your spouse or family to cancel unnecessary policies and obtain premium refunds, or to continue important policies for protection, as needed.

Tax-Related Information

Your notebook should include a copy of your most recent federal and state income tax returns and information about any quarterly estimated tax payments due in the current year. You should also provide the location where you keep copies of your prior income tax returns. If you have ever filed any gift tax returns with the IRS, copies should be included.

Employees

If you have household employees, it is helpful to know the financial arrangements with each employee, such as payroll (\$/hour) and benefits (vacation). Provide the name and contact information for the payroll service provider, the insurance agent handling the workers compensation insurance, and the name of the insurance carrier with the policy number.

Records, Checks and Vouchers

The location of the following should be listed:

- usual place where you keep pending bills and estimated tax vouchers for the current tax year
- your safe deposit box(es) and keys (e.g. "in my top right desk drawer,") especially if your will and other original documents are in the box. Include the name of the bank and the address of the branch office where the box is located, if applicable. You may want to provide an inventory of what is in the box.
- Prior checking account statements and check registers, as well as where you store your unused checks and current check registers.
- Any other financial records that you think may be useful to your spouse, family or executor.

It is helpful to maintain a list of all bills that are debited automatically from your checking account(s) and whether charged monthly, quarterly or annually.

Inheritances

If you inherited property from someone within the past ten years, provide the name of the person, his or her date of death, and the name and address of the executor, if known to you. Your estate may be entitled to some tax savings.

Helping Your Spouse and Family After Your Death *(continued from page 8)*

Setting up an Estate Notebook will, realistically, take quite some time, perhaps most of a year. An ideal time to begin is early in the calendar year, after you have received year-end annual statements and are researching and collecting information for preparation of your income tax returns. Once your notebook is established, you should update it annually and will find that this task is not arduous. Backing up the information on a secure electronic device, as part of your personal disaster recovery plan, is advisable.

It is never too early to begin this project. Not only will working on it highlight issues that need to be addressed (e.g. clear title to an asset, make gifts to reduce your taxable estate, and fund your trust), but you will feel great satisfaction in having organized your affairs, knowing that you will have eased the burden for your spouse and loved ones.

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than developed markets and operating margins that are often on par with or better than domestic markets.

Attractive Opportunities in a Low-Rate World

Finally, it is worth reiterating our framework for choosing stocks for the Equity Income Matrix (originally described in our Summer 2010 TrustLetter). When evaluating potential additions to this model portfolio, our goal is to focus on well-run companies that we regard as offering an attractive mix of current income and opportunity for capital appreciation, and not the highest yield *per se*. Our criteria for dividend-growth

stocks represent a framework that attempts to capture dividend sustainability, dividend growth potential, and yield.

With interest rates at or near the lowest level in decades, dividend-based investing approaches are gaining attention.⁴ For many investors approaching or in retirement, the security of a growing dividend stream can be very appealing. Our Equity Income Matrix is designed to meet the needs of clients who require more current income, lower volatility, or both objectives.

¹ *Variety*, December 31, 1980. <http://www.variety.com/review/VE1117794542?refcatid=31>.

The New York Times concurred noting in the December 11, 1981 issue, "Is the Arab Euro-dollar really a good subject for movie banter?" and "The dramatic possibilities of the material are weak at best, and its satirical underpinnings are nowhere to be found." The passage of time has not been particularly kind to the movie either, as Internet Movie Data Base (IMDB) users rate *Rollover* a mere 5.3 stars out of a possible ten (534 users).

² Bernstein Research, "Quantitative Research: Prospects for a Large Cap Comeback," June 10, 2011. Exhibit 5: Returns in the last decade have been the worst for the largest 50 stocks in nearly seventy years.

³ Sources: Current level, FactSet. Average since 1960, calculation is Cambridge Trust Company from data compiled by Prof. Robert Shiller. <http://www.econ.yale.edu/~shiller/data.htm>

⁴ Levisohn, Ben. *Wall Street Journal*, "It's Payback Time! The Markets are Rewarding Companies That Pay Dividends," August 27, 2011.

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