



SUMMER 2012



trust & investment
perspectives

Money Isn't Making the World Go 'Round

by Willard N. Woolbert



In both 2010 and 2011, decent market rallies gave way to concerns about either economic growth or financial chaos in the third quarter. In each case, the market was rescued by monetary authorities. In 2010 it was Ben Bernanke, announcing at a meeting in August, that the Federal Reserve (Fed) would begin a program of buying bonds or what was dubbed Quantitative Easing (QE2). In 2011, the Fed initiated "Operation Twist", a program designed to lower long-term interest rates by selling short-term bonds to buy long, in hopes of lowering borrowing costs for prospective homeowners. The Fed was joined in November 2011 by the European Central Bank (ECB) with their idea of providing longer-term funding for European banks through the Long Term Refinancing Operation (LTRO) program. In each case, markets rallied strongly in reaction to the injection of

money into the system. As we enter the third quarter of 2012, with equity markets in the second quarter generally weaker in response to both growth fears and financial system risk in Europe, are we likely to repeat the cycle of market panic and monetary authority rescue in 2012?

In May and June, markets were shaken by the inability of the Greeks to form a government after their mid-May elections. The second election, in early June, raised the question of whether the eventual government would repudiate the "austerity agreement" and move Greece closer to exiting the Euro block. This, along with bank problems in Spain, began to drag both Spain and Italy into the crisis and interest rates in those countries moved high enough to create concern over their access to credit. An offer of capital for the Spanish banks deepened the crisis, as

current and future buyers of Spanish debt became subordinated creditors to the bank bail-out funds. At the end of June, the European Union (EU) moved to quiet the markets with plans to provide funds to recapitalize banks under a pan-European scheme. They also proposed to empower the European Financial Stability Facility (EFSF) to buy Spanish and Italian debt to reduce rates on their debt.

In the U.S., at its June meeting, the Fed extended its Operation Twist until the end of 2012. The action came as a result of developing weakness in the U.S. economy, particularly in the labor market. Initial unemployment claims have trended higher over the past several months and monthly reported gains in employment have stalled.

China, too, has entered the stimulus race with recent **continued on page 4**



Jonathan M. Heckscher Joins Investment Team

As Senior Vice President and Director of Fixed Income activities, Jonathan Heckscher brings a wealth of experience and expertise to Pennsylvania Trust's Investment team. He joins the firm from Logan Capital Management where he served as Managing Director of Fixed Income Investments. Prior to Logan, Jonathan was Executive Director and Vice President of LOM Asset Management, a Bermuda-based money manager. At Pennsylvania Trust, his responsibilities include all aspects of Fixed Income activities as well as investment policy.



Keep Calm and Carry On

Summer finds us at the halfway point in the year, a traditional time of hiatus, yet neither the unseasonably hot weather nor the economic landscape offer much in the way of respite. The peaks and valleys of the financial news have been wearying. Fallout from the financial crisis, now four years out, continues, and haunts investor sentiment. The divisiveness in politics remains disheartening. Progress in resolving the European debt crisis is tenuous and far from resolution.

One forecast suggests a bearish outlook, another, cautious optimism. The second quarter showed a continued increase in consumer spending, resilient corporate profits, and improved housing starts. Yet recent job growth numbers are not encouraging and unemployment remains high. An analysis in *The Wall Street Journal* suggests that the economy is entering a "soft patch" that will see slow growth. Many observers, myself among them, have suggested that we must adjust our thinking and expectations. There is a "new normal." In many respects, we are in uncharted territory where previous patterns and cycles are moot. Several strategists and fund managers, interviewed for a piece in *The New York Times*, are noting a positive attitude toward stocks that perhaps could speak to a broader paradigm. "Conditions have been difficult for so long that investors are becoming used to it." In this view, sick is the "new healthy." With so many difficult issues in so many places, it is a challenge to find a balanced coping perspective.

I am reminded of the tag line from the British World War II poster "Keep Calm and Carry On." Originally issued when war broke out in 1939, the poster was one of several designed by the British Government's Ministry of Information intended to strengthen morale. When a poster was rediscovered several years ago, its appealing message struck a relevant chord that quickly became a pop culture sensation, reissued on merchandise from mugs to doormats.

Reflecting on the newfound popularity of this old adage, *The Economist* suggested that it taps into Britain's mythic image, "unshowily brave and just a little stiff, brewing tea as the bombs fall." And while I do not think that the gravity of the economic state of America or the world comes close to that of the Second World War, perhaps there is something to be taken away from the message of preparedness and resilience that won the day.

Pennsylvania Trust is steadfast in our commitment to provide outstanding professional and personalized service that allows our clients to meet their wealth management goals. Our analysts diligently

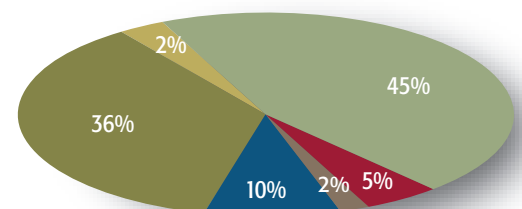
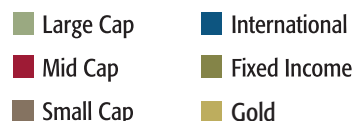
study market trends, analyze news and review revenue and earnings announcements. Pennsylvania Trust's tax experts are up to date on changes and potential changes in laws and legislation. In this issue, Randy Thomas takes a close look at the outcomes should the "Bush Tax Cuts" expire as well as suggesting ways to minimize the potential deleterious effects. Bill Woolbert, Chief Investment Officer, discusses the weakening impact of monetary policy on the markets and economy, and the need to resolve structural issues in Europe and fiscal ones in Washington.

There are too many variables at play to make it possible for even the most prescient expert to accurately predict the future of the financial picture at home or abroad. Maintaining a forward thinking approach requires patience and perseverance and perhaps, to borrow another British phrase, a "stiff upper lip."

Richardson T. Merriman

Chairman and Chief Executive Officer

Balanced Asset Allocation



TRUST TALK

Tax Reform: What If?

by Randy G. Thomas, CPA, CFP®



The future of the “Bush Tax Cuts” is at the center of one of the most heated debates in Washington. While the 2010 Tax Relief and Job Creation Act extended tax cuts for two years, President Obama has adamantly stated that he is not in favor of continuing them across the board. Politicians on the other side of the aisle disagree with equal fervor.

While it is not possible to predict the ultimate outcome of this divide, it is prudent to be aware of the possible scope of a change, and, more important, to initiate steps that can be taken to manage the potential outcome. The information that follows highlights changes that could go into effect on January 1, 2013 should the Bush Tax Cuts expire.

Taxpayers will see the following changes to the rates on earned income and investment income:

	2012	2013
Highest Marginal Rate	35%	39.6%
Long Term Capital Gains	15%	20%
Qualified Dividends	15%	39.6%
Medicare Contribution Tax	N/A	.9% on wages over \$200,000
Medicare Surcharge	N/A	3.8% on “net investment income”

The expiration of the Bush Tax Cuts will hit investment income of high income taxpayers especially hard. Qualified dividend income will increase to the highest marginal rate for ordinary income, or 39.6%, and long term capital gains will be taxed at the increased rate of 20%. For “high income” taxpayers (\$250,000 for married taxpayers filing a joint return, \$125,000 for married couples filing separately and \$200,000 for all other

taxpayers), these tax rates could be increased an additional 3.8 percentage points as the Unearned Income Medicare Contributions Tax (UIMCT) increases their tax rate on net investment income. Net investment income includes interest, dividends, annuities, royalties, rents, and capital gains. Net investment income also includes passive trade or business income. Distributions from most retirement plans are not considered investment income for purposes of the UIMCT tax.

Married taxpayers, filing jointly, will pay an additional 0.9% Hospital Insurance Tax (HI) on their earned income (wages) over \$250,000. Married taxpayers filing separately will pay this tax on wages over \$125,000 and all other taxpayers will pay this 0.9% tax on wages over \$200,000. Earned income includes salaries and earnings from self employment income. Higher income taxpayers with both earned income and investment income could see their tax rate increase 4.7% as both the UIMCT and HI may apply to their investment and earned income. Many could see a combined total tax rate approaching 55%.

Estates and trusts are also subject to the UIMCT, but only on their undistributed net investment income, including capital gains. The threshold for applying the UIMCT is much less than that for individuals — \$11,650 for 2012, so estate and trusts could be facing the biggest income tax burden of all.

Planning for these increases now can help reduce taxes down the road. Investing taxpayers can take the following steps to reduce net investment income:

- Invest in tax-exempt vehicles such as state and local bonds

- Invest in tax-deferred vehicles. Non-dividend paying growth stocks do not increase investment income until they are sold. Tax deferred annuities may provide a reduction in current income and may be appropriate for reducing the UIMCT.
- Reduce or defer capital gains in 2013
- Realize capital gains in 2012 to avoid or minimize the UIMCT in 2013
- Elect out of installment sale treatment and recognize gain in 2012 to avoid the UIMCT and potentially higher capital gains rate
- Roth IRA conversions in 2012 instead of 2013

Planning for estates and trusts can also reduce the amount of investment income subject to UIMCT. Trustees and executors should consider making income distributions to beneficiaries that are not subject to UIMCT, thus reducing the income of the estate or trust and the corresponding tax. Since the threshold (\$250,000 for married filers, \$125,000 for married filing separately and \$200,000 for individuals) is much higher than that for estates and trusts, the UIMCT can be eliminated if the beneficiary’s income remains below the threshold.

Tax reform will make tax planning for high-income taxpayers and estates and trusts all the more significant. Pennsylvania Trust’s team of knowledgeable and experienced tax experts urge you to consider how potential tax changes may impact you and to initiate a discussion to plan a strategy that allows you to continue to meet your investment goals.

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

continued from page 1 reductions in their bank reserve requirements, complemented by an outright cut in lending rates. In the U.K., the Bank of England has reduced rates and expanded their program of quantitative easing. We now have a global move to increase the quantity and lower the price of money, with little or no impact on the markets. This summer, it seems as if the rescue has come and investors are unimpressed!

If we are going to have a Euro block in any way similar to what exists today, it is going to require some form of socialization of the sovereign and bank debt within the seventeen countries. When the various financial entities in Europe speak of deposit guarantees, a pan-European bank, or Eurobonds, markets rally, as these are ways in which German cash can be leveraged across weaker European economies. When the action involves ad hoc purchases of debt, the market rightly sees this as only temporary and moves on. The difficulty in this is that in order to create any such pan-European solution, governments have to give up some of their independence — on budgets and banking regulation at the least. It is the price of a decade of profligacy that not all are willing to pay. Until they are, and it will probably take a significant crisis to move to that point, announcements from Europe will move markets but not change the direction.

In the U.S., the Fed has played a key role in keeping markets moving over the past three years. But two programs of QE, followed by the recently extended Operation Twist, have had a diminishing impact on markets as these efforts have failed to produce much of an improvement in the economy. In the same way that investors are looking for a sustainable fix to the crisis in Europe, we believe that the U.S. needs to begin to address our own budget deficit. The immediate problem is the so called “fiscal cliff” that will occur at year end. On December 31, the expiration of the “Bush Tax Cuts,” the imposition of spending cuts related to the debt ceiling compromise of 2011, new taxes on investment income to fund healthcare, changes in estate taxation, higher payroll taxes, and a variety of other special interest tax break expirations will create an approximate 4% drag on gross domestic product (GDP). This in an environment where GDP might be growing at 2.5%. The likely, although certainly not optimal, outcome is that some or all of these issues get extended and the impact is reduced. However, despite the recent posturing by politicians, old and new, on both sides of the aisle, this extension will not be in place until after the November election, creating a significant level of uncertainty for all, investors and businesses alike.

We are entering the season of noise — political and, unfortunately, economic as well. Markets will rise and/or fall on an announcement that Spanish debt will be bought by the EFSF or that the Fed will try to further reduce interest rates. But, we will remain directionless until forced to get to the heart of the matter — true financial integration in Europe and discipline to our own chaotic budget situation.

Mr. Woolbert is Senior Vice President and Chief Investment Officer at Pennsylvania Trust.



Walking for the Red Cross

As part of Pennsylvania Trust’s Community Service efforts, an enthusiastic group of colleagues and family members lent their support to the Philadelphia Red Cross Walk & Run to Save Lives. This 5K, held in Fairmount Park, benefits the Red Cross’s emergency relief efforts in Philadelphia.

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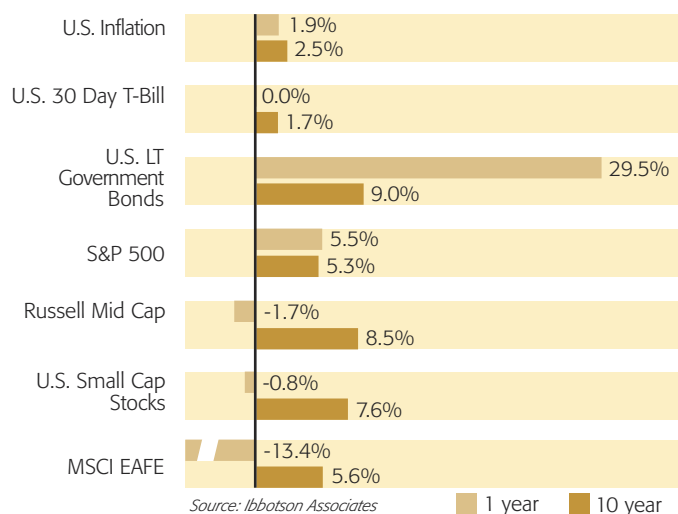
Pennsylvania Trust is committed to conduct all our relationships with integrity and to maintain the highest ethical standards; provide outstanding professional and personalized services; produce superior investment results consistent with client objectives; and retain exceptionally skilled individuals, empowering them with state-of-the-art technology.



Market Indicators

	Current	Three Months Ago	One Year Ago
Stock Indices	6/30/12	3/31/12	6/30/11
Dow Jones Industrial Average	12,880	13,212	12,414
Standard & Poor's	1,362	1,408	1,321
U.S. Treasury Yields			
2 Year	0.3%	0.3%	0.5%
5 Year	0.7%	1.0%	1.8%
10 Year	1.6%	2.2%	3.2%
30 Year	2.8%	3.3%	4.4%

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	11.0%	+
Consumer Staples	12.2%	-
Energy	10.5%	-
Financials	13.9%	=
Health Care	11.8%	=
Industrials	10.1%	=
Information Technology	20.1%	=
Materials	3.3%	+
Telecommunication Services	3.4%	=
Utilities	3.7%	=

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