

WINTER 2013

trust & investment
perspectives

More Madness **by Willard N. Woolbert**

Who knew that fiscal cliffs could propagate? Having reached beyond the last moment at the turn of the year, Washington managed to extend the Bush era tax cuts for those making less than $400,000/$450,000 a year. Congress and the administration were unable to agree on spending issues and thus leave us with three new "cliffs" to address in the new year. Part of the 2012 cliff was to be mandatory spending cuts in defense and health care as part of the 2011 debt ceiling debate, and was thought sufficient to force a compromise to avoid the cuts. These were postponed until March 1: cliff number one. The debt ceiling returns as a problem, with estimates of the government running out of borrowing capacity centered around mid-February: cliff number two. Lastly, as we do not have a budget, the government is being run by continuing resolutions. The current resolution expires on March 31: cliff number three. One definition of madness is doing the same thing over and over and expecting different results. We will have essentially the same players negotiating each of these issues in February and March and it would indeed be madness to expect anything other than last second compromises on all of these issues. There will likely be no grand bargain, only further postponements and rolling cliffs to deal with. So, in this environment of perpetual conflict, possible downgrades of U.S. debt and ongoing uncertain business conditions, why aren't we selling stocks and bonds in anticipation of a market collapse that must come in such an environment?

Our answer would be, not yet, and perhaps not for some time. There are certainly critical long-term deficit issues building in the U.S. as well as other developed economies. This and other cost increases will eventually require significant adjustments to budgets, but it is unlikely to occur in the U.S. until there is some political realignment or bond and currency markets force change. We see neither of these in the immediate future. Rather, we would argue that in the U.S. we are likely to continue to "muddle through." Marginal change and delay may be the outcome from Washington, but beyond its borders there is evidence of economic stability and even some growth as we get deeper into 2013. Tax increases and the effects of the drawn-out fiscal negotiations are likely to depress results much of the first half of 2013.

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Charles T. Lee, III, Joins Investment Management Team

With over 25 years of experience in the investment management industry, Chip Lee, Senior Vice President, is a welcome addition to Pennsylvania Trust's investment management team. He joins us from Brown Brothers Harriman where he was responsible for both institutional and private client relationships with a special emphasis on delivery of wealth management solutions. Chip serves as a trustee for both the Schuylkill Center for Environmental Education and the Philadelphia City Institute.

The Power of Words

The season of reviews has been upon us. List upon list of the best movies, songs, books, businesses, people, and pictures have been compiled. While I do wonder about this year-end compulsion to create rankings, I am curious enough to steal a glance and compare my mental selections or maybe note how many of the books that I have read appear on this year's tally.

Earlier this month, *National Public Radio* aired a segment on "Words of the Year," more specifically Merriam Webster's most looked up words of 2012. I was struck by how something as simple as a single word might reflect the span of a year. This year's winners, two rather than one for the first time since the selection began in 2003, are *socialism* and *capitalism*. Peter Sokolowski, the editor at large, explains, "Traffic on our website (http:// merriam-webster.com/) for this unlikely pair about doubled this year from the year before as the health care debate heated up and discussion intensified over 'American capitalism' versus 'European socialism.' The thing about an election year is that it generates a huge amount of very specific interest." Runners-up were also politically motivated and included *democracy, globalization* and, in what Sokolowski suspects is a nod to the economy and "a glimpse into what qualities people value in job seekers," the word *professionalism* is up 12% over last year.

As a point of comparison, let me relay that the lexicographers at Dictionary.com chose *bluster* as its Word of the Year. The head of content for this free online dictionary also attributes the choice to the historical events of this year: the election and weather events; with the added appeal of bluster's double meaning: to roar as wind or to be loud, noisy or swaggering. And there are other contenders. *Hashtag* received top billing from the American Dialect Society with, no surprise, *fiscal cliff*, making a strong showing. And while fiscal cliff was not elected number one on any word list, the phrase receives full coverage in this issue of *Trust and Investment Perspectives*. Chief Fiduciary Officer Leslie Bohner addresses some of the specific results and implications of the latest legislation and Bill Woolbert, Pennsylvania Trust's Chief Investment Officer, takes a pointed look at what the months ahead portend.

Socialism or capitalism? Bluster or hashtag? Can a one word (or two) possibly reflect an entire year? I contemplate what single word I might choose to describe Pennsylvania Trust. Certainly the word *trust* comes most quickly to mind. Trust is indeed a strong word with implications of moral value and honesty. The etymology comes from the Latin base "fid," hence fidelity or trust. I will forgo a lengthy history discussion, but as the banking industry evolved, the word trust expanded to include the notion of a trustee and the offering of fiduciary services, as we do today. Many familiar and venerable banking institutions chose to include the word trust in their name, certainly to advertise the services offered but just as importantly to take advantage of word association. For example, when Judge Thomas Mellon launched Pittsburgh's Mellon National Bank and Trust Company in 1870, it was lauded as a symbol of stability, enterprise and public responsibility.

Fortunately, I am not confined to choosing a single word and I take advantage of every opportunity I have to expand on the definition of Pennsylvania Trust. I have deep and resounding pride in the people and services that define our company. This year and every year, we are committed to you, our valued clients and friends, and our mission of providing outstanding professional and personal service that meets each individual's financial objectives.

As 2012 drew to a close, the nation found itself heavy hearted, mourning a senseless tragedy and searching for a measure of solace in our collective grief. It is at times like these that I find myself particularly grateful for a caring and generous community, appreciative of family and friends and all that we have to be hopeful and thankful for.

Richardson T. Merriman
Chairman and Chief Executive Officer

TRUST TALK

The Fiscal Cliff Compromise: Questions and Answers

by Leslie Gillin Bohner, Esq.

On New Year's Day, Congress passed the American Taxpayer Relief Act of 2012 (the "Relief Act"), preventing the country from going over the dreaded "fiscal cliff." A summary of the key provisions follows:

- An increased tax rate of 39.6% applies to taxable income over $400,000 for individuals, $425,000 for heads of household and $450,000 for married couples filing jointly
- An increased tax rate of 20% applies to long-term capital gains and qualified dividends for taxpayers with taxable income exceeding the thresholds set for the 39.6% rate
- A $5.25 million estate, gift and generation-skipping transfer (GST) tax exemption (indexed for inflation), a 40% rate for transfers in excess of the exemption amounts, and a permanent "portability" provision
- A "patch" of the Alternative Minimum Tax (AMT) for 2012 and subsequent years
- A personal exemption phase-out applies to taxable income over $250,000 for individuals, $275,000 for heads of household and $300,000 for married couples filing jointly
- Revival of "Pease" limitation on itemized deductions
- Charitable contributions from IRAs are allowed, with special retroactive rules for 2012

Many of our clients have called with questions about the Relief Act and we thought it would be helpful to share our answers to some of those questions:

Q: If I earn less than $450,000, but more than $250,000, will I still be subject to the 3.8% Medicare surtax?

A: Yes. The Relief Act did not make any changes to the 3.8% Medicare surtax which took effect on January 1, 2013. For individuals, the surtax is imposed on the lesser of "net investment income" (NII) or the amount by which modified adjusted gross income (MAGI) exceeds the threshold of $200,000 for single filers, $250,000 for married couples filing jointly and $125,000 for married couples filing separately. NII includes interest, dividends, royalties, annuities, rents, and net capital gains derived from the disposition of property, but does not include distributions from IRAs or qualified retirement plans, or income from tax exempt municipal bonds.

Example: *A married couple filing jointly has $300,000 in wages and $150,000 of NII for a total MAGI of $450,000.*
The 3.8% tax applies to $150,000 of income – the lesser of NII of $150,000 or $200,000, the excess over the MAGI threshold of $250,000.

Note that if this couple had taxable income greater than $450,000, their effective top rate for capital gains and qualified dividends could rise to 23.8%

Q: If I have taxable income greater than $450,000, will all of my dividend/capital gain income be taxed at 20%?

A: The answer depends on the amount of your taxable income and the amount of your capital gain income.

Example: *A married couple has $500,000 of taxable income, including $200,000 of long term capital gains/qualified dividends (LTCG).*
*LTCG taxed at 15% = the **lesser** of:*
*(1) Net capital gain not subject to 0% rate = **$200,000***
OR
(2) Excess of taxable income not subject to 39.6% ($450,000) minus (taxable income less net capital gain)
*$450,000 – ($500,000-$200,000) = **$150,000***

LTCG of $150,000 will be taxed at 15% and LTCG of $50,000 will be taxed at 20%.

Q: What happens if I sell my house in 2013?

A: Home sales have the ability to trigger the 3.8% Medicare surtax if the taxpayer's MAGI exceeds the $200,000/$250,000/$125,000 threshold and the taxpayer has capital gain on the sale in excess of the exclusion amount of $250,000 for single taxpayers and $500,000 for married couples.

Example: *A married couple has wages of $500,000 and sells their principal residence in 2013 for a net gain of $700,000. Their MAGI is $700,000 (wages of $500,000 plus gain on sale of residence of $200,000 after applying the $500,000 exclusion) and their NII is $200,000 (gain on sale of residence after applying exclusion). The 3.8% surtax applies to $200,000, the* ***lesser*** *of:*

(1) NII of ***$200,000***

OR

(2) The excess of the couple's MAGI of $700,000 over the $250,000 threshold $700,000 - $250,000 = ***$450,000***

Q: Since the estate and gift tax exemptions are now set at $5.25 million (indexed for inflation), and portability is permanent, do I still need to do estate and gift tax planning?

A: Yes. As mentioned in previous newsletters, every individual should have a will, durable power of attorney, and healthcare power of attorney. And the benefits of trusts, such as professional asset management, creditor protection, and providing for family members with special needs, have not changed. Additionally, for those who did not act in 2012, there is now time to consider gifting strategies, such as grantor retained annuity trusts (GRATs), valuation discounts and GST dynasty trusts, the favorable benefits of which Congress could reduce or eliminate in the future. Finally, annual exclusion gifts are still the simplest method to reduce the size of your estate and benefit your family. The amount of the annual gift tax exclusion has increased from $13,000 to $14,000 for 2013.

Q: I took my Required Minimum Distribution (RMD) in December 2012. What are the new rules for charitable gifting from an IRA?

A: The Relief Act reinstates the ability of a taxpayer over 70½ to make a tax-free distribution (up to $100,000) from a traditional or Roth IRA directly to a qualified charity. Because this "charitable rollover" provision was not available in 2012, the Relief Act includes two special rules: (1) an RMD taken in December 2012 can be reallocated as if paid to a charity in 2012 if a cash contribution in an amount less than or equal to the RMD is made to a qualified charity before February 1, 2013; and (2) a payment made directly to a charity in January 2013 can be treated as a tax-free 2012 distribution from an IRA.

Pennsylvania Trust's team of professionals is available to guide you through the complexities of the Relief Act. We welcome the opportunity to address your individual questions as they relate to your overall financial goals.

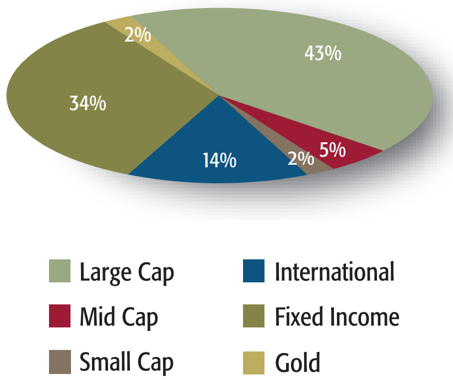
Ms. Bohner is Senior Vice President and Chief Fiduciary Officer at Pennsylvania Trust.

Bruce Brown Recognized at National Philanthropy Day Awards Luncheon

Senior Philanthropy Consultant Bruce Brown was recognized by the Association of Fundraising Professionals' Philadelphia Chapter at their annual National Philanthropy Day awards luncheon.

Bruce was honored with the 2012 President's Award for his quarter century of mentoring fundraisers, plus an array of charitable works.

Balanced Asset Allocation



continued from page 1 However, pent-up demand related to housing and corporate capital spending should boost second half results. Current state and local government fiscal positions seem to be improving and this should help both demand and employment. Globally, economic activity appears to be improving. Europe remains in recession, but recent data from China indicates better activity levels there. This nascent growth is unlikely to upset the bond market. Short-term rates are and will be anchored by the Federal Reserve. In December, the Fed abandoned its pledge to keep rates low through 2015 in favor of linking the timing of an increase to unemployment (6.5%) and inflation (2.5%) targets. We see neither of these targets likely to be hit in 2013. Longer-term rates may drift higher as economic activity improves. The increase in rates may be enough to cause bond returns to be down in 2013, but not sufficient to upset other markets. Corporate and particularly municipal credits look relatively attractive entering 2013.

With the bond market a hostage of the Fed and the U.S. dollar unlikely to come under pressure with other major central banks engaged in their own forms of easing, the equity market is left to be the barometer of investor attitudes towards the various cliff debates to come. Under a "muddle through" outcome we are likely to see volatility in the equity market as attitudes about compromise ebb and flow. This was the market in the fourth quarter of 2012. While the S&P 500 was largely unchanged from the election until year-end, we had almost daily reaction to the news from Washington on the "cliff" debate. We are willing to take this risk of volatility because equities still are inexpensive relative to fixed income alternatives, they are broadly under-owned by most investors, and oddly provide a strong current yield alternative to the Fed's repressed level of interest rates.

Last minute compromise is now the norm. We will hope that, whatever the compromise becomes, it will provide enough time for the markets to reflect the slowly improving economy and the longer-term attractiveness of equities.

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

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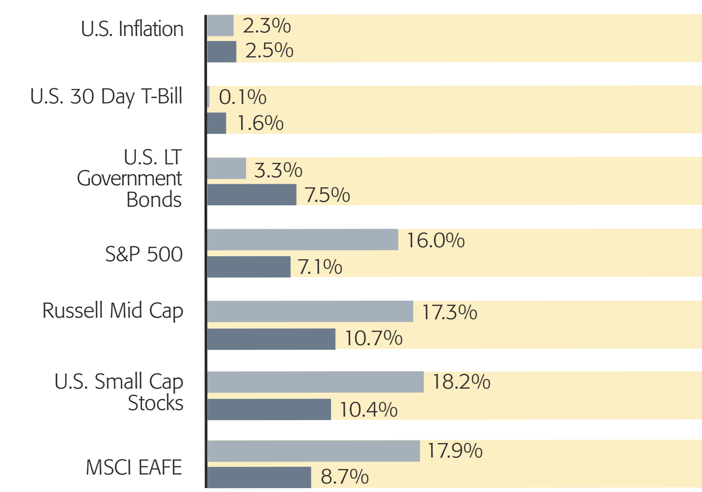
Pennsylvania Trust is committed to conduct all our relationships with integrity and to maintain the highest ethical standards; provide outstanding professional and personalized services; produce superior investment results consistent with client objectives; and retain exceptionally skilled individuals,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

Market Indicators

	Current	Three Months Ago	One Year Ago
Stock Indices	12/31/12	9/30/12	12/31/11
Dow Jones Industrial Average	13,413	13,437	12,217
Standard & Poor's	1,462	1,441	1,257
U.S. Treasury Yields			
2 Year	0.2%	0.2%	0.2%
5 Year	0.7%	0.6%	1.0%
10 Year	1.8%	1.7%	1.9%
30 Year	3.0%	2.9%	2.9%

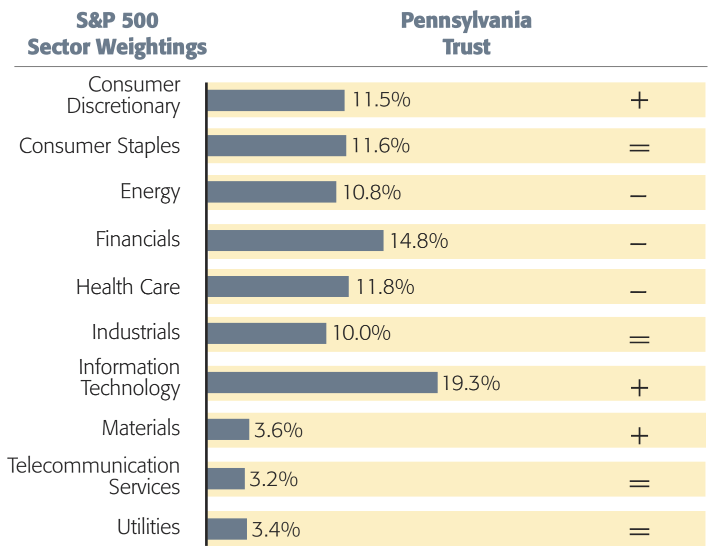
ANNUALIZED RETURNS OF SELECT ASSET CLASSES



Source: Ibbotson Associates

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:



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