GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

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William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

The jobs report on Friday, June 2nd settled little with respect to the current economy. The published 138,000 job gain was about 100,000 less than rumored, yet was enough to lower the unemployment rate to 4.3%, recording the lowest rate since 2001. That is not a misprint, the last time we recorded an unemployment rate of 4.3% was in 2001. For the month, wages grew two tenths of a percent, bringing the annual run rate of increase to 2.5%. The labor participation rate declined to 62.7%, which continues to be three percent lower than the participation rate of 66% recorded in the year prior to the beginning of the 2008 recession. On a forward basis we need to add about 100,000 jobs monthly to maintain stable employment and consistency in the participation rate. U-6 unemployment recorded another month of decline to the 8.4% level, and the initial jobs claims which measures those applying for assistance for the first time also stood at a historical low level of 240,000, meaning fewer people were being fired during the reporting period. Most assume that the Federal Reserve will continue its current policy of adding 0.25% to the Fed Funds rate when they meet June 13th & 14th. Data revealed that revised GDP grew at 0.7% for the first quarter of 2017, which confirmed a pattern of weak growth in Q1 for three consecutive years. The identifiable reasons this year were not weather related as in the past two years but rather energy price reductions and inventory weakness. What these offsets really emphasize is that our economic growth continues to be incremental and, therefore, forecasts are difficult to prove accurate. The Fed has signaled their view that the economy is expanding and their regional Fed data adds to their confidence. Auto sales were as expected, showing slight declines from the historic pace of 2016. Home prices jumped 6.3% as days on market tumbled and inventory shrank. Great news for sellers as most of the regions reported the largest increases since 2007. Buyers are coming to this market paying one percent higher mortgage rates than they were a year ago, but seem comfortable with the still sub-5% average rate for conforming loans.

Skill set gap and productivity declines continue to be a drain on potential economic growth acceleration. Almost all employment services report significant gaps between job openings and qualified applicants. It is not likely that those still unemployed will bridge the skill gaps necessary to fill those jobs.

Commentary, continued

As the labor force tightens, the skill gap jobs will most likely be filled by those already employed and enrolled in some form of training. This rotation within the labor force is not unusual and often accelerates when labor becomes scarcer. As the competition for human capital increases, employers increasingly look inside their own employed base to seek candidates to train and meet the skill set voids.

The dismal earnings reports from many retailers, as well as notices of store closings and resulting job losses, is a signal of a larger problem for many within the sector. Consumers are changing behaviors and those retailers caught without an appropriate response to that change will not last. The velocity of change in consumer buying preferences is very challenging for many retailers, who must maintain some brick and mortar shopping experience capacity yet also be able to fulfill the online demand acceleration. This challenge is not just being felt in the soft goods markets such as clothing, fashion and housewares, but also in the retail restaurant and retail banking businesses as well. Same-store sales in food and beverage outlets have posted consecutive monthly declines, even in the face of consistent modest economic growth. To be certain, more product has come on market as the economic recovery ages, yet more competition alone is not the reason for sales declines. Total unit volumes have decreased in retail food and beverage by over four percent during the last five years. Several retailer associations have engaged in consulting studies to track consumer preferences and trends. Their conclusions are sobering for many in the sectors that are affected. Increasingly, consumers want an Amazon fulfillment of service across many consumption choices. The traditional shopping experience desired by many in the past is giving way to an increasingly technology-savvy consumer who prefers to allocate their time doing things they like to do rather than what they have to do. The bandwidth of available options for consumers is exponentially increasing and leaving the traditional brick and mortar retailer in the dust. Those retailers who have an established brand dominance, presence in a digital environment, capacities to respond and an infrastructure to serve the logistical requirements will stay connected and in touch with their existing and future customers, thereby earning the right to continue in this rapidly changing environment. Those that don't will continue to announce store closings, layoffs, poor earnings and ultimately their demise.

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The velocity of change that we often talk about has implications for many sectors of the economy. Autonomous vehicles are racing towards us yet we, as a nation, have little understanding of the myriad of change impacts that they will have upon employment and the economy. The storm currently raging in the retail marketplace is real and already upon us. Those that succeed will do so because they accepted the future, analyzed what they needed to change in their business models as well as strategic plans and executed the results that allowed them to remain relevant.

Some were surprised when they woke to the news that Mark Fields was relieved of his duties as CEO of Ford and was replaced by non-Ford exec Jim Hackett. My sense is that it was precisely the mobility and digital change that is upon us that created the requirement for change in leadership at Ford. Mark Fields was a marketing guy, and a very good one at that. He served Ford very well for three decades in many leadership roles prior to being President and CEO, but all of those roles were in marketing and divisional operations. He was excellent at what he did, but apparently could not lead the change from a car company to a mobility company. Jim Hackett didn't have the baggage of being a car company veteran. He wasn't mired down in the traditional business model of a global automotive company. His long tenure at Steelcase transcended several really big changes in office furniture business models. Perhaps it was his successful tenure as a change leader at Steelcase that allowed it to remain hugely successful when others in the industry faded into the sunset that caught the attention of Bill Ford.

A new tag line for the current administration might be "It's complicated" or maybe even, "It's more complicated than we thought." Big ideas require big plans that include big strategies and solid execution and they always include massive negotiation and compromise. Every politician understands this but some come harder to the lesson than others. Health care reformation, tax reform, infrastructure and immigration involve big ideas, plans, strategies and compromises. They also require leaders that are focused on the prize and not the distractions and noise that surrounds them. Currently we have big ideas and numerous announcements but no observable traction. Exceptional leaders attract great talent and enable that talent to drive results by resourcing and empowering them. Weak leadership views everything through a sense of self and is full of hubris. The President is not alone in his hubris and love of self; there are many in Congress who possess the same character traits. It is when they all practice these traits simultaneously that we have a lack of traction and a squandering of time and ideas.

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Michael F. Odar, CFA
President

“Work-life balance is a concept that can mean different things to different people. To us, it means a culture built on teamwork and trust...”

A Balanced Approach

I am excited and proud to announce that for the sixth year in a row Greenleaf Trust was named a Best & Brightest Place to Work in West Michigan. The Best and Brightest Companies to Work For® competition identifies and honors organizations that display a commitment to excellence in their human resource practices and employee enrichment. Organizations are assessed based on categories such as communication, work-life balance, employee education, diversity, recognition, and retention. This year we were also recognized as an elite winner in the work-life balance category. This is the fourth time that we have been recognized as an elite winner in West Michigan and each time has been in a different category (2015- Compensation, Benefits, and Employee Solutions; 2014- Employee Achievement and Recognition; and 2012- Employee Enrichment, Engagement, and Retention).

Beyond being recognized as influential and trend-setting in employee enrichment, what is even more meaningful is that work-life balance is something that we focus on. In fact, work-life balance was a component of our 2016 Strategic Initiatives (Culture) and was a theme directly cultivated from our annual Strategic Planning Survey. The Strategic Planning Survey is given to every person in our company so that they can provide their strategic thoughts and ideas on how we can get better.

Work-life balance is a concept that can mean different things to different people. To us, it means a culture built on teamwork and trust that allows for flexibility to address what is most important. We hire talented people who are innately dedicated to helping those they serve (our clients) and have a need for achievement. We work in a demanding field and have a high performance culture that puts our clients first and requires we hold each other accountable to get things done. All that said, we recognize people also have demands at home and need time for enjoyment.

Since our people have high demands at work and can have high demands at home, we provide them with the flexibility to do what they need to do. And with a generationally diverse workforce, that can mean a lot of different things. It could mean the flexibility to take their aging parent to a doctor’s appointment during the middle of the day or to others the flexibility to leave early and attend their young child’s recital. We also leverage technology to provide people with the flexibility of remote access. With all of these demands, it’s also important that our people take time to enjoy themselves. That’s why we provide everyone with the opportunity to participate in a first rate Wellness program and vacation days are ample and encouraged.

We have experienced and studies have shown that with the right work-life balance people are ultimately more productive, take fewer sick days, and are more likely to stay with their employer longer.

Is an Irrevocable Trust an Illusion?

George F. Bearup
Senior Trust Advisor

Did you know that the irrevocable trust that is created on your death may not be as permanent as you think it will be? A trust can become irrevocable when it is created, or more often is the case, the trust becomes irrevocable upon its creator's death. A fair assumption of most trust creators (technically called a settlor) is that once their trust becomes irrevocable, it cannot later be changed. In truth, a trust settlor's belief that their trust is irrevocable and nonmodifiable is pretty much an illusion.

In today's world regarding trusts, especially those that are intended for an extended duration, flexibility is the 'name of the game.' The goal is to add provisions to a trust, or when the trust is silent to have state laws in place that gives someone the ability to adapt the trust to reflect changes in property or tax laws. In some circumstances it may be advantageous to be able to alter the trust's terms to better serve the changing needs of a trust beneficiary. But should all irrevocable trusts be allowed to depart from the terms that the settlor selected? Can too much flexibility be used to eviscerate an irrevocable trust?

One example where flexibility in adapting a trust is welcome is when grandparents create a trust for their grandchild, and the grandchild possesses the right to withdraw a portion of their trust share when a specific age is attained. But if their grandchild later suffers a disability, and begins to receive governmental benefits that are based on the grandchild's financial need as a result of that disability, the right of the grandchild to withdraw part of the trust's assets will cause them to forfeit their eligibility to receive governmental benefits. If the trust could be modified to eliminate or suspend the grandchild's withdrawal right, the grandchild will continue to receive governmental benefits. In this instance, a subsequent modification of the trust would be a good thing.

> "… the irrevocable trust that is created on your death may not be as permanent as you think it will be… "

Individuals engaged in estate planning often spend considerable time and expense to create trust provisions tailored to meet their objectives and what they perceive to be the trust beneficiary's needs. But seldom is attention given to several statutes which permit their irrevocable trust to be subsequently altered, or in some cases prematurely terminated. A sampling of Michigan Trust Code sections which permit an irrevocable trust to be modified or terminated follows:

- Nonjudicial Settlement Agreements: Interested individuals, i.e. beneficiaries and trustees, (note, not requiring the probate judge's approval) can enter into binding nonjudicial settlement agreement with respect to any matter that involves an irrevocable trust, so long as a material purpose of the trust is not violated by that agreement. While a

Irrevocable Trust, continued

nonjudicial settlement agreement cannot be used to modify or terminate the trust, the trust's administrative provisions can be altered by such an agreement.

- Modification by Consent of Beneficiaries and Trustee: A probate judge can modify or terminate a trust if the trustee and all the beneficiaries consent to the modification or termination, but only if the probate judge concludes that the modification is consistent with the trust's material purpose, or in the case of the trust's termination, the continuance of the trust is not necessary to achieve the trust's material purpose.
- Modification Due to Unanticipated Circumstances: A probate judge can modify the trust's administrative or the dispositive provisions, or terminate the trust, because of circumstances not anticipated by the settlor, and the judge concludes that the modification or termination will further the settlor's stated purpose for the trust, or if there is no stated purpose, the settlor's probable intention with regard to the trust's purposes.
- Reformation to Conform to Settlor's Intent: A probate judge can reform the terms of the trust, even if the trust's terms are clear and unambiguous, to conform the trust's terms to the settlor's intention. Clear and convincing evidence must exist to identify what the settlor's intention was, and that the trust's terms were the result of a mistake of either fact or law.
- Modification to Achieve Tax Objectives: A probate judge can retroactively modify the trust's terms to achieve the settlor's tax objectives, so long as the proposed changes are not contrary to the settlor's probable intention.
- Terminate Uneconomical Trust: Despite a trust's express duration, an uneconomical trust can be terminated earlier by the probate judge upon notice to the trust beneficiaries.
- Trust Protector Powers: If the trust instrument names a trust protector, that protector can be given the authority in the trust instrument to amend or terminate the trust, potentially contrary to the settlor's probable intention, or the trust's clear material purposes.
- Trustee Decanting: Michigan recently adopted a decanting statute. If the trustee is given the discretion to make income or principal distributions from the trust to the trust beneficiary, the trustee can create a new trust with different trust provisions that may impact when and how the beneficiary receives the distributions. While not all irrevocable trusts can be decanted under Michigan's statute, the trustee's ability to move trust assets to a different trust that is created by the trustee, not the settlor, may cause settlors some discomfort.

Note that many of these Michigan statutes refer to a trust's material purpose. That technical concept is not defined in Michigan's Trust Code. Moreover, Restatement (Third) of Trusts on which a major part of the Michigan Trust

"... seldom is attention given to several statutes which permit [an] irrevocable trust to be subsequently altered, or in some cases prematurely terminated."

Code is based, notes in its comments that material purposes are not to be readily inferred when a court is called upon to construe a trust instrument. If considerable attention has been devoted to craft a trust's provisions, it is important to expressly identify the settlor's material purposes in the trust instrument to guide future modifications, if any, or possibly prevent future modifications from being implemented that might otherwise interfere with the trust's material purposes.

For example, consider grandparents who create a trust for their spendthrift grandchild. The trust instrument conditions the exercise of the grandchild's withdrawal right upon a showing of the grandchild's minimum credit score. Because of this condition imposed on the grandchild's access to the trust's assets, there is a pretty good chance the grandchild will resent that condition that stands between the grandchild and an inheritance. A subsequent modification to the trust instrument that reduces or eliminates the credit score condition would frustrate the grandparents' intent to use the condition to incent a change in their grandchild's financial responsibility. A possible modification to remove or rewrite the condition might be one occasion when too much flexibility is a bad thing. The ability to modify, or perhaps even terminate a trust, is critically important if the settlor creates an incentive trust with conditions imposed that are designed to alter the trust beneficiary's behavior by using trust distributions as an inducement. If the settlor intends to impose conditions on the beneficiary's eligibility to receive future trust distributions, knowing in advance that the beneficiary will be unhappy about the condition, then the settlor might want to expressly prohibit a future modification of the trust by an unhappy trust beneficiary (and a potentially compliant trustee who must constantly deal with a disgruntled trust beneficiary).

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Most of Michigan's Trust Code is what is referred to as default legislation, meaning that its provisions will not apply to a trust instrument if the trust instrument clearly opts out of the Code. Consequently, if a settlor does not want the trustee to exercise the decanting power that is available under the Code, the trust instrument should expressly deny the trustee's use of that statutory power.

Flexibility permits a trust to be modified to respond to changes in the law (tax or property), to correct errors, and to update antiquated or obsolete trust provisions. But that flexibility often needs to be balanced against the need to preserve and carry out the settlor's intent reflected in the trust's material purposes. When meeting with an estate planning attorney, it is important to discuss how the anticipated trust might be changed after it becomes irrevocable, and what limits might need to be imposed to prevent a future trust modification, trust decanting, or trust termination.

Sharon A. Conran, J.D.
Vice President
Trust Relationship Officer

Collector's Items

For many individuals, collecting items such as artwork, antiques, jewelry, books, dolls or other items that represent a lifelong passion can create a challenge for a fiduciary (Trustee/Personal Representative) or beneficiary if careful planning is not in place at the time of the individual's death.

If you own a collection, deciding what is to become of your collection when you are no longer around to care for it is not something to take lightly. When it comes to planning the distribution of your assets, your collection should not be a roadblock to a successful transfer of your assets, but a culmination of the success you have achieved in your lifelong endeavor.

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The options available for the distribution of the collection can range from selling the collection to distributing the collection, in its entirety or separately, or establishing a plan (trust/foundation) to continue the collection in perpetuity.

For your fiduciary, the distribution of the collection can be delayed or circumvented if proper planning is not done in advance. Before you reach the decision as to how you want your collection distributed upon your death, don't overlook the steps you should take to ensure the best for the items you have treasured and enjoyed collecting.

Depending on the type of collector or the items collected, you may have already begun the planning process. Generally, the following planning steps should be taken when distributing a collection:

1. Valuation: Knowing the value of your collection may be key to the distribution of your collection. The types of collections people have are limitless. Because each collection is unique, you should regularly obtain an appraisal by an experienced and qualified appraiser. The appraiser should specialize in your type of collection. The appraisal is not only good for insurance purposes; it also provides a value should you decide to gift an item during your lifetime. The appraisal values may also be used should you choose to distribute some items separately, or gift the collection to one beneficiary while equalizing the gift among the other beneficiaries using other assets from your estate. It should be noted that with some collections, dismantling the collection could diminish the value or could complicate an estate plan when the intent is to provide equal shares to beneficiaries.
2. Inventory: Maintaining an up-to-date inventory of your collection is essential for the valuation and distribution of items. Without an up-to-date inventory, items in your collection may be excluded, especially if an item is loaned out to a museum or other institution for display or in storage. Conversely, if an item is listed on the inventory but not located, the fiduciary could spend time looking for an item which was previously sold or gifted. The inventory can be as simple as a spreadsheet or

handwritten journals.

3. Record Retention: The history of the acquisition of any item is extremely important when it comes to valuing an item. This often deals with establishing an item's authenticity (artwork/historical items). If the proof of the item's authenticity cannot be found, the item will hold little, if any, value. Chain of title is very important with respect to some collections and it matters where the item is located and whether or not the item can be removed easily (prompting questions regarding opportunity for potential for forgery replacement). Records provide information as to the original purchase price, where the item was purchased, whether appraisals and proof of authenticity were done at the time of acquisition. If an item is sold or gifted during your lifetime, records should be retained to reflect the change of ownership and alert the fiduciary that this item is no longer a part of the collection.
4. Insurance: Collections can be insured as part of the contents of your home, scheduled items (riders), or under a blanket coverage. Most insurance carriers require an inventory and/or appraisal of the items prior to insuring scheduled items, but you should check with your insurance provider to determine what is required.
5. Beneficiaries: Knowing the right beneficiary for your collection will provide you with great peace of mind. Your collection has most likely provided you with great joy and for some individuals has been a lifelong endeavor. You should discuss with your potential beneficiaries, family members, friends, or charities, whether they are interested in your collection and want to maintain it. If they don't want the collection, the beneficiary may sell the items for their value rather than continuing the collection. For charities, ask whether the charity will be willing and financially able to maintain the collection, or will the collection be sold. Based on your discussions with your beneficiaries, you can establish a plan that works for both your intent for your collection and your beneficiaries.
6. Preservation: Certain collections require special treatment. Instructions should be provided regarding the maintenance and preservation of the collection. Depending on the items, there may be a requirement to have the items in storage facilities that have temperature and humidity controls, limited light exposure or other requirements that a fiduciary or beneficiary may not be familiar with. If a collection requires special storage, maintenance, and conditions for preservation, will the fiduciary and ultimately the beneficiary have sufficient funds or liquidity to maintain the collection. The cost of moving the collection and the logistics of distributing the collection should also be included in the plan. If the collection is to be sold, is the location of the collection the best location for the sale or is there a plan to transport the collection to an auction house

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or venue that will generate the largest return on the collection and invite bidders who are truly interested in your collection?

7. Experts: While building your collection, you may have encountered or used various experts related to valuing, purchasing and selling items. It is helpful to a fiduciary and beneficiaries, who may not be an expert in your type of collection, to be aware of experts you have worked with. It is a good idea to include in your records a list of dealers, appraisers, museum curators and other collectors in your area of collecting and gives insight into who you trusted and worked with and whom you recommend to the fiduciary for any insight if necessary.
8. Advisors: Work with your financial advisors, attorneys and tax planners during your planning. Gifting of your collection during your lifetime may have tax advantages or disadvantages. Collections are taxed at different income tax rates, and valuations of collections reported on a Federal Estate Tax Return are often subject to valuation challenges. Establishing a trust or foundation during your lifetime, with the specific purpose of continuing your collections, may be an option for you and your beneficiaries that may result in extensive tax planning. Be aware of your classification with relation to your collection as this may affect tax ramifications as to whether you are a dealer, investor, collector or creator. Your advisors can work closely with you to create a successful plan for you and your collection.

Owners of collectibles are often significantly invested in their collection, both financially and emotionally. The perfect plan will protect that investment and establish an appropriate succession plan in order to preserve the collectibles as both a personal legacy and a valuable resource to the owner’s beneficiaries.

Greenleaf Trust is available to you, your beneficiaries and your estate planning attorney to assist with planning, reviewing and carrying out your desires.

An Insider's Guide to…

Steven J. Christensen, CFP®, CTFA
Wealth Management Advisor

Fiduciary management and administration is a topic often discussed within this publication. The Department of Labor's definition of a fiduciary indicates that advisors must act in the best interests of their clients and to put their clients' interests above their own. But what does that mean in execution? What processes are in place to accomplish this objective and what value is actually translated to a client relationship through the implementation of a "fiduciary offering?"

This article will provide you with an insider's perspective to how fiduciary oversight and administration is implemented at Greenleaf Trust. I will highlight this in the context of a few critical components of process, components in which I feel substantial value is created.

Every client relationship starts with a conversation. Who are you? What is important to you? What concerns you most? What aspirations do you have for your wealth? How much, where, invested how and in what structures, is part of that conversation as well. Once this important personal and financial information is gathered and understood it is presented by your Greenleaf Trust representatives to a group of their peers. The goal of this exercise is to bring to bear the collective wisdom of the organization onto your unique situation. It is an opportunity to collectively discuss what strategies could work best and what are the corresponding risks. This initial advice is memorialized within a Wealth Management Plan which begins setting the course of how your wealth could be managed at Greenleaf Trust. The key concepts here are: a written plan, collective wisdom and an agreement of how to best go about executing on what is most important to you. It starts and ends with the best interests of the client.

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If the Wealth Management Plan sets the course in the beginning of a relationship, the Investment Policy Statement, or IPS, keeps things current and on track. Every managed relationship at Greenleaf Trust requires a current IPS. The IPS provides critical client information including: overall financial objectives, investment time horizons, ability and willingness to assume risk, tax circumstances and what, if any, unique circumstances need to be considered. Account level investment objectives with percentage ranges for asset class allocations are also an important component of an IPS. The IPS is a critically important fiduciary management tool and for our clients it serves as another written agreement to how much risk is being taken and why.

Internally, much of the information contained within the IPS serves as data input for our systems. The data provides guardrails for risk assessment and oversight. Our annual account review or AAR process compares current portfolio characteristics and circumstances against the data. The goal of this process is to identify variances for several risk management metrics as well as provide an opportunity to offer a narrative to the specifics of a particular

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relationship. As the name of this process implies, every managed account at Greenleaf Trust is reviewed annually and new accounts are reviewed within 60 days of opening. Client Centric Teams consisting of a Trust Relationship Officer, a Wealth Management Advisor and a Team Service Coordinator are responsible for completing the AAR process. As a Wealth Management Advisor my portion of the AAR process focuses on investment portfolios.

Some of the portfolio risk management items included in this process are: asset class deviations greater than 5% from the assigned investment objective, variances in sub-asset class allocation from the guidance provided by Greenleaf Trust's Research Team, identification of concentrated securities and the identification of any investment not actively followed by a Greenleaf Trust Research Analyst. Trust Officers have their own set of risk issues to address, all of which can be summarized as, what have we agreed to do, are we doing it and is there documentation to prove it? Any variance that has been identified creates a breach in the system requiring an explanation into the circumstances, reasoning and plan going forward. Those breach responses are evaluated by the Account Review Committee which audits the logic of those responses to make sure the risks are understood and managed appropriately. If the Account Review Committee feels as though additional work or insight is required a flag and corresponding task is created. This will ensure nothing falls through the cracks. The entire process provides the broader organization insight to what is being done for our clients. The process also provides the Account Review Committee an opportunity to render an opinion whether current relationship management actions correspond with what has been identified to be in the client's best interest.

On the highest level our partnerships with internal auditors, Crowe Horwath, and our regulators, The Department of Insurance and Financial Services, provide external oversight. These relationships are managed in large part by our Director of Compliance who has functional accountability to the Audit Committee and reports directly to the President. These groups and individuals know well the responsibilities of a fiduciary and are laser focused on ensuring Greenleaf Trust is acting in our clients' best interest.

Risk is best managed when it is identified and understood. Greenleaf Trust takes the position that the business of a fiduciary is a risk management business not a risk avoidance business. Among corporate trustees this somewhat unique stance results in a "can do culture" willing to seek and understand. Our clients are complex and they require a fiduciary that knows them and understands what is important to them. Through the fiduciary oversight and administration process there are always issues to comment on and exceptions to address. However, they better line up with what has been determined to be in the client's best interest or else as Ricky Ricardo would say "Lucy! You got some 'splainin' to do!"

The New Silk Roads

John Graham
Guest Contributor

On 10th of April, a freight train loaded with consumer goods left Stanford-le-Hope in Britain bound for the east coast of China. The journey took the train 17 days via Europe, Russia, Kazakhstan, Kirgizstan, and Xinjiang, the Chinese province that abuts Central Asia. This route cuts around two and half months off the maritime alternative and is far cheaper. The train from Britain and others like it are part of a new Silk Road that transports Chinese goods to destinations all over Europe, among them, all the Dell computers sold in Europe. While the ancient Silk Road grew organically from cattle herding routes over the mountains in Central Asia into the network of routes travelled by Marco Polo and named by the German geographer Baron Ferdinand von Richthofen (uncle of the World War I ace), the tracks that now link China with Europe are part of a deliberate strategy of capital investment by the Chinese Government. But, this road is not just a clever piece of infrastructure. It is part of the biggest soft power exercise of all time.

“The train from Britain and others like it are part of a new Silk Road that transports Chinese goods to destinations all over Europe…”

President Xi recently hosted an international conference in Beijing to formally launch this project, oddly named One Belt One Road (yi dai yi lu – sounds better in Mandarin), which he first proposed in 2013. While the potential expenditure can be added up in several ways, China has essentially undertaken to build out upwards of a trillion US Dollars of infrastructure in Central Asia, South Asia, and Southeast Asia. In addition to the road, rail, and pipeline routes through Central Asia, the New Silk Road includes spurs linking new deep water ports in Pakistan and Myanmar to Western and Southwest China. These spurs are designed to facilitate the flow of oil and gas (and a host of other raw materials) into China and open export routes to Europe that will cut weeks off the delivery of consumer goods from factories in Eastern China. As part of the exercise, President Xi has also announced that this initiative will be paired with a 21st Century Maritime Silk Road (a route which in the ancient world was every bit as important as the overland Silk Road) that will open deep water ports, repair facilities and free trade zones along the maritime route from Eastern China, through the South China Sea, the Indian Ocean, and the Arabian Sea. This sea borne Silk Road will facilitate and protect the flow of oil and gas from the Middle East, natural resources from Africa, and components from Southeast Asia to China’s industrial heartland on her East Coast.

To finance this new “Chinese Dream,” the billions of dollars in investment represented by these projects, China has recruited her state-owned banks and her state-owned construction companies. Moreover, China has recruited other nations in Asia to set up new multilateral institutions such as the Asian Infrastructure Investment Bank and the Silk Road Fund to help finance One Belt One Road and make it, at least on the surface, less unilateral in nature. Taken together, these institutions will provide hundreds of billions of dollars of funding for construction, most of which will happen outside of China in Central, South and Southeast Asia. Just at a time when the US has withdrawn from the Trans Pacific Partnership, China is moving to become the region's leader in financing Asian economic development. The China Development Bank and the Export-Import Bank of China already lend more in Asia than the World Bank and Asian Development Bank combined (both US/Japan dominated institutions). Certainly, goods and services will flow over these new Silk Roads, but so will Chinese influence and power.

One Belt One Road is designed to accomplish many objectives. Three stand out as critical to the Chinese leadership.

The first problem China needs to address is The Malacca Problem. The Straits of Malacca run for 500 miles between Malaysia and Indonesia with Singapore at their southern end. Being 40 miles across as the narrowest point, the Straights represent a strategic choke point of great concern to China. Eighty percent of all China's oil and gas is shipped via this tiny waterway. At least one third of the world's trade flows through these waters and there are no good alternative routes. Hence, finding a way to diversify delivery routes for its energy supplies is critical for China's security.

"China has essentially undertaken to build out upwards of a trillion US Dollars of infrastructure in Central Asia, South Asia, and Southeast Asia."

One Belt One Road addresses this problem in several ways. The initiative includes pipelines as well as road and rail links to bring Central Asian energy (largely from Kazakhstan) into China via its Western province, Xinjiang. In Pakistan, a new deep water port, Gwadar, is being built on the Arabian Sea. This port will be the terminal for a pipeline and rail link that will run through Pakistan, climb the Himalayas and finish in western China, linking with the southern section of the new Silk Road in Xinjiang (this project has the unwieldy name of The China-Pakistan Economic Corridor, CPEC). A similar facility is being built in Myanmar, at Kyaukphyu. From there, pipelines will ship oil and gas through Myanmar to Yunnan Province in Southwest China. Also mooted is a road and rail link between Kolkata in India and Yunnan.

The second objective of One Belt One Road is economic development in Western China. Until now, Chinese economic development has been unbalanced. The East coast has grown rapidly with the West lagging behind creating problems with migration from West to East and disaffection among those remaining in the West. Of major concern to the Chinese government is the Uyghur ethnic minority in Xinjiang. Historically, this Muslim group has not had links with radical Middle Eastern Islam, but the government fears radicalization in the face of slow economic development (relative to Eastern China) and administration by ethnic Chinese from the East. Hence, policy makers in Beijing continue to encourage both investment in and migration to Xinjiang. The New Silk Road and CPEC are designed to create the kind of economic development that they hope will ease ethnic tensions in Xinjiang and bind the residents, Uyghur and non-Uyghur, to the rest of China thus contributing to "Social Harmony" a long time, key Chinese goal.

The third goal of One Belt One Road is to reassert China as a great power on the global stage by expanding its economic and, to some extent, military influence in Asia. After two centuries of domination by external forces and internal chaos, China has emerged as the world's second largest economy. National rejuvenation is a stated goal of the Chinese leadership. The One Belt One Road initiative, laid out as a cooperative venture among most of the countries in the Asia, is designed to let China step into its new role as regional leader using economic development as a spearhead in her drive for security and influence.

These new Silk Roads require cooperation, infrastructure investment and, less discussed by the Chinese, military power to protect them. Most of the construction for these projects will be carried out by Chinese companies and, often, by Chinese workers. Nonetheless, the economic impact on the countries in which these projects take place will be substantial. With this impact will come an expansion of Chinese influence beyond its borders in a way not seen in modern times.

When asked, it appears that, with some reservations, most of the countries involved in One Belt One Road are happy with China's new role. Clearly, the investment is welcome and will, by and large, benefit the countries who participate. However, most of these countries would also like to see a power balance in the region provided by the US with via her military and through investment. This is particularly true now that the Chinese have asserted territorial rights over a wide swath of the South China Sea, an area called the Nine Dash Line, setting up a dangerous confrontation with the US, who beyond her regional treaty obligations has concern for the vast amount of shipping which flows through the disputed area. For the next several years, the US, one presumes, will remain the dominant military power in South-East Asia just as Russia remains the dominant military power in Central Asia. However, One Belt One Road can clearly tip the balance of economic and political power in favour of China as her investments outpace those of the US (and Russia) and begin to factor into the decision making of the countries in the region.

> "When asked, it appears that, with some reservations, most of the countries involved in One Belt One Road are happy with China's new role"

Overall, One Belt One Road seems like a very well thought out, well-funded and coherent piece of foreign and economic policy. However, things can clearly go wrong. Investing vast amounts in foreign countries runs the risk that regime change may render those investments valueless. Moreover, with much of the work being carried out by Chinese companies and Chinese workers, the financing, control, and efficiency savings which arise from this strategy can be negated by local unhappiness with a perceived lack of benefits for local companies and local workers. In addition, the natural desire to protect substantial investments, such as deep water ports, sets up the potential for confrontation with foreign powers on the high seas. Inland, pipelines, roads and rail tracks will run in many countries through disputed territory held de facto by rebel forces rather than by country government. Finally, Mother Nature can wipe out months of work in a heartbeat. In 2010, the Karakoram Highway between Pakistan to China, a major joint project, was buried under huge lake by an earthquake. Repairing this damage will be part of the CPEC. The road project in and of itself will cost $11 billion.

As investor, this is a difficult opportunity to exploit. With most of the initial benefits flowing to Chinese companies, it's hard to see ways to directly invest in the major players, many of whom are Chinese State owned companies. While Western companies will, no doubt, try to become involved, there is no clear path for them to do so. Perhaps the best strategy for the overseas investor is to be aware of and educated about One Belt One Road and then be alert to investment opportunities which might emerge be they in heavy equipment, defence, or other areas. Given the amount being spent and the potential for shifts in geopolitical alignment, opportunities will certainly arise.

The overriding question from an investor's point of view might be whether China can afford these new Silk Roads. Over the past few years, the debt to GDP ratio for China has risen substantially. In 2015, it hit 250% of GDP when government, corporate and consumer debt are combined. One Belt One Road could be viewed as long term investment which will bring returns for years to come. On the now popular "dynamic scoring basis", returns from the project should flow for years to come. However, as we have discussed, there are execution problems and this kind of investment is always at risk when it is done abroad. With the recent Moody's downgrade in mind, investors should be careful to factor China's debt worthiness into any investment decisions.

One last thing to bear in mind. One Belt One Road is President Xi's legacy project. Should problems with it mount, his authority could be undermined. While he is likely to get this way this fall at the Party Conference when the new Party leadership is unveiled, spending vast sums of money in this way could well give ammunition to his enemies should some of the larger projects fail.

If you would like to read deeper into this fascinating project, here some source materials which you might enjoy:

Books

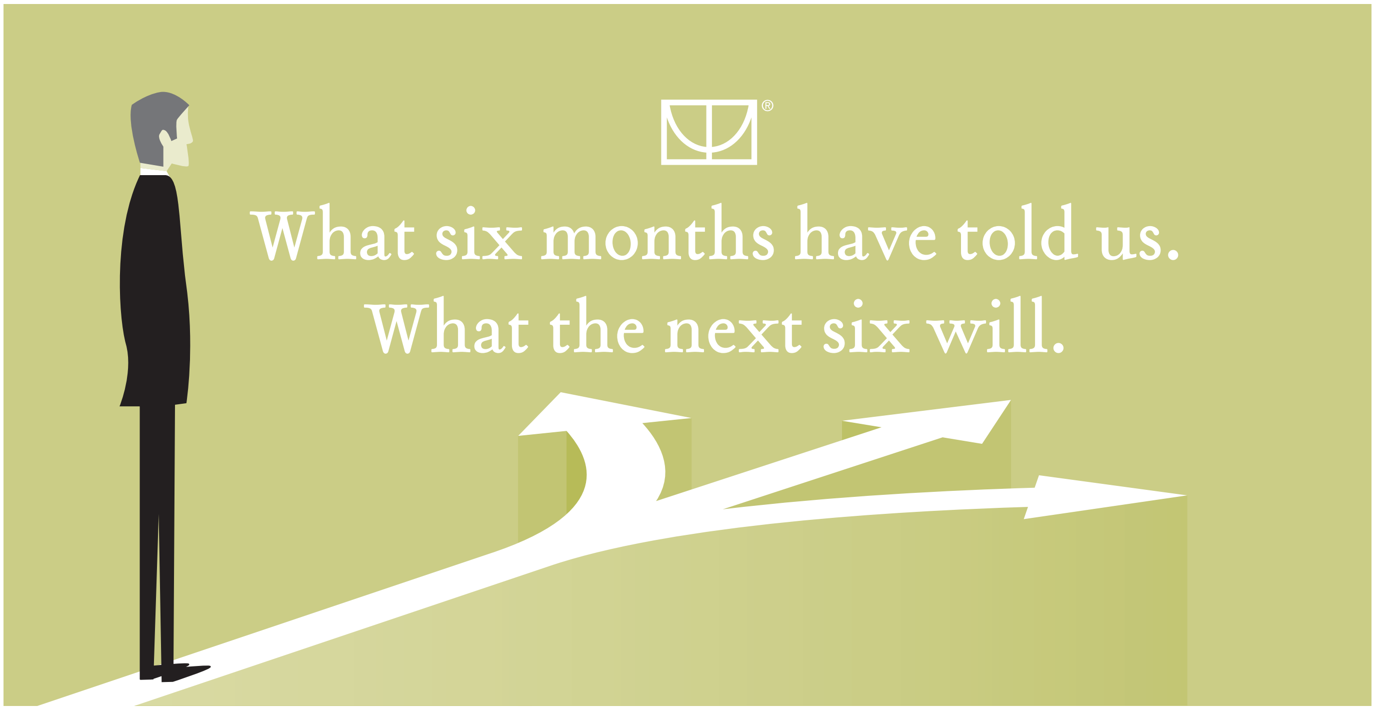
China's Asian Dream, Tom Miller

Monsoon, Robert Kaplan

Articles

Behind China's Gambit in Pakistan, Dan Markey and James West, The Council on Foreign Relations

China's New Silk Road, Nadege Rolland, The National Bureau of Asian Research



Please join us for a timely mid-year seminar on two interrelated topics:

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The presentation will allow ample time for audience Q&A.

Thursday, July 13, 2017 | 11:30am–1pm
Lunch will be served.

Arcadia Ballroom
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RSVP to rsvp@greenleaftrust.com by July 6.
Seating is limited.

Christopher D. Burns, CFA, CPA
Fixed Income Analyst

High Yield Municipal Bonds

In this article, I will introduce you to high yield municipal bonds. I will describe the investment characteristics and highlight why we are favorable on the asset class. We particularly like the long-term outlook for clients that pay higher income tax rates. I hope to give you a high-level understanding of our opinion of the merits and the risks of these investments.

Description and characteristics:

- High yield municipal bonds are bonds that are tax-free or not subject to the alternative minimum tax (AMT) and either not rated or rated below investment grade (BB+ or Ba1 or lower).[1]
- U.S. states, U.S. territories, or local governments or agencies issue these bonds. [1]
- Bonds are issued in multiple sectors including: [1, 2]
  - ◊ Tax-backed: these bonds are secured by tax collections of the issuer.
  - ◊ Revenue: these bonds are secured by a pledge of revenues of the issuer and can include:
    - Tobacco bonds: secured by settlement payments from major tobacco companies and various U.S. states.
    - Healthcare: hospitals, nursing homes, and other facilities.
    - Education and charter schools: private colleges, charter schools.
    - Transportation: airports, toll roads, port authorities.
    - Industrial development: often issued by corporate borrowers which can be similar to corporate high yield credits.
    - Various other sectors.
- These bonds tend to be longer in maturity or duration. They normally finance long-term projects. The weighted average maturity on the S&P Municipal Bond High Yield Index was 19.8 years as of April 28, 2017. The modified duration was 7.44.[1]
- The universe of available investments is small. There was about $121 billion outstanding in the S&P Municipal Bond High Yield Index as of April 28, 2017. This compares with the broader municipal bond market at around $3.8 trillion. The taxable aggregate bond market has around $19.4 trillion outstanding. [1, 3, 4]

Merits:

- Higher tax-free income:
  These bonds typically offer higher levels of income than investment grade bonds due to their riskier credit profile. In addition, most of the interest income is exempt from federal income tax. This is a significant advantage for clients paying the top marginal tax rate of 39.6%.
- Low correlation to traditional stocks and bonds:
  We invest the bulk of our clients' assets in stocks and investment grade

bonds. We try to diversify risk by including investments with low correlation to those asset classes. High yield municipal bonds have historically been good diversifiers. Their performance has had relatively low correlation to traditional stocks and bonds.

- Historically low default rates and high recovery rates:
  Default rates on high yield municipal bonds have been much lower than speculative grade corporate bonds. In addition, recovery rates after default have been higher. This gives us confidence that the credit risk of these assets is manageable.
  - ◊ From the period 1970-2015, the cumulative 10-year default rate of speculative grade municipal bonds was 8.18%. This compares with a cumulative default rate of 29.42% for speculative grade global corporates.[5]
  - ◊ Over this same period, Moody's estimates the average recovery rate for municipal bonds at 66%. This compares with an average recovery of 53% for corporate bonds.[5]

Risks:

- Interest rate sensitivity:
  The maturity profile of high yield municipal bonds is longer than other sectors of the bond markets. This makes the market value of these bonds more sensitive to changes in interest rates. High yield municipal bonds could experience poor performance if interest rates go up significantly.
- Liquidity:
  Liquidity is rather poor for these assets. There can be periods when selling pressure causes poor performance. Liquidity is poor because the universe of available investments is small and credit analysis for these bonds can be complicated.
- Performance can be volatile:
  High yield municipal bonds can have periods of volatile performance. This is different from traditional investment grade bonds that are more stable. The most extreme example is from the credit crisis when the S&P Municipal Bond High Yield Index declined 31.5% from 4/30/2007 to 12/31/2008. For context, the S&P 500 was down 36.7% and the Bloomberg Barclays Aggregate Bond Index was up 10.3% over the same period.[6]

Conclusion:

The Investment Research team is favorable on the long-term prospects for high yield municipal bonds. We like the prospect of high tax-free income and low correlation to other investments. In addition, we worked hard to find a manager who we believe effectively manages the risks mentioned above. Our goal is to achieve the first tenet of our investment philosophy, to maximize after-tax returns for a given level of risk. If you have any questions or want to discuss these ideas further, please contact a member of your Client Centric Team.

Sources:

1. S&P Dow Jones Indices. (n.d.). Retrieved May 30, 2017, from http://www.spindices.com/indices/fixed-income/sp-municipal-bond-high-yield-index
2. Davern, M., CFA (2016, November). Is High Yield High Risk? A Primer on Municipal High Yield. Retrieved May 30, 2017, from https://www.nuveen.com/Home/Documents/Default.aspx?fileId=62878
3. SIFMA statistics, US Bond Market Issuance and Outstanding, Q4 2016. Retrieved May 30, 2017, from http://www.sifma.org/research/statistics.aspx
4. Bloomberg Barclays Aggregate Bond Statistics, retrieved from Bloomberg 5/30/2017.
5. Moody's Investor Services (2016, August 12) Public Finance - US: US Municipal Bond Defaults and Recoveries, 1970-2015. (n.d.). Retrieved May 30, 2017.
6. Performance retrieved from Bloomberg on May 30, 2017.

Stock Market Pulse

Index	5/31/17	Total Return Since 12/31/2016
S&P 1500	558.27	8.04%
Dow Jones Industrials	21,008.65	7.47%
NASDAQ	6,198.52	15.76%
S&P 500	2,411.80	8.66%
S&P 400	1,721.69	4.30%
S&P 600	832.17	-0.21%
NYSE Composite	11,598.03	6.07%
Dow Jones Utilities	726.62	11.84%
Barclays Aggregate Bond	109.76	2.38%

P/E Multiples	5/31/17
S&P 1500	21.7x
Dow Jones Industrials	18.5x
NASDAQ	23.6x
S&P 500	21.4x
S&P 400	23.9x
S&P 600	25.9x

Key Rates

Fed Funds Rate	0.75% to 1.00%
T Bill 90 Days	0.73%
T Bond 30 Yr	3.00%
Prime Rate	4.00%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	558.27	21.7x	1.97%
S&P 500	2,411.80	21.4x	2.03%
Dow Jones Industrials	21,008.65	18.5x	2.45%
Dow Jones Utilities	726.62	NA	3.45%

Spread Between 30 Year Government Yields and Market Dividend Yields: 1.03%

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