GREENLEAF® TRUST

Perspectives

A Greenleaf Trust Newsletter

JANUARY 2013 VOLUME 22, ISSUE 1

William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

For those who are students of our country's current and future economic challenges, the passage of the "Fiscal Cliff" legislation was an ominous reminder that the legislation was only one part of the three-legged stool solution to righting our fiscal ship, and that the legislation itself paled in comparison to what was truly needed. Let's devote some time to examining the three legs of the fiscal stool and evaluate our progress.

REVENUE INCREASES

The following are bullet points of the 133 page bill that the Senate offered, the House ratified and the President signed into law on New Year's Day.

Tax Changes (projected to raise $600 Billion over the next ten years)

- Employment taxes will increase from the current 4.2% to 6.2% for all employed. This change will mean an additional tax of approximately $1,000 for the average working family per year.
- Income tax rates will increase from 35% to 39% for couples earning in excess of $450,000 per year.
- Capital Gains rates will increase from 15% to 20% for joint filers making in excess of $450,000 per year.
- Itemized deduction limits will be capped on joint filers that earn $350,000 per year.
- Estate tax rates increase to 40% from 35% and retain the $5 million dollar exemption per individual, indexed to inflation.
- An inflation patch was added to alternative minimum tax regulations that will relieve many middle income tax payers from the AMT.
- Long-term unemployment benefits were extended for one year.
- Several tax credits that benefit lower wage earners were extended for five years.
- The "Sequestration" spending cuts were deferred for two months to give all parties the opportunity to come to agreement on spending cuts and debt ceiling levels.

What does all of the above actually do? Well, not much. The Congressional

Commentary, continued

Budget Office scores the legislation as increasing our annual deficit to $329 Billion rather than the projected $390 Billion if the tax cuts had, as previously structured, been extended. More importantly, they project our total deficit increase to be $3.9 trillion over the next ten years, creating a total deficit of in excess of $20.0 trillion dollars.

Clearly, the legislation was incomplete—and the knowledge that our current elected representatives and executive leaders could not reach agreement on weak legislation leaves us with amplified concern that they will ever come to reasonable consensus on the really necessary work to be done. For those who thought we could not become another Greece over the next decade, I have some unsettling information for you.

"Clearly, the legislation was incomplete—and the knowledge that our current elected representatives and executive leaders could not reach agreement on weak legislation leaves us with amplified concern..."

Several months ago, I shared some data from what I believe is a really important piece of work by Mary Meeker of Kleiner, Perkins, Caufield & Byers. I recommended it then and do so again with an even greater sense of urgency. Mary has updated her data and it is available online at http://www.kpcb.com/insights/2012-usa-inc-key-points. Some of her data relevant to our fiscal calamity is as follows:

- America is losing our edge and, while some of that is a natural progression of globalization, most is self-inflicted.
- Financial strength is vital to competitiveness.
- Positive cash flow and a strong balance sheet are keys to financial strength.
- America needs conviction and leadership.
- America is funded by tax dollars and Americans in general are ignorant of how their dollars are being spent.

I have offered before the notion that the issue is a combination of not only what we spend but where we spend it. Solving one without the other will be inconsequential and disastrous. We will not only be debt-strangled, we will also have a crumbling infrastructure, irrelevant technology, inferior education, inadequate healthcare and a weak defense. There are alternatives to the above, but every year that passes without solutions in place makes the future solution far more egregious. The pain will cease when we stop shooting ourselves in the foot. Ideology has no seat at the table of solutions, and ideologues must not be invited—the facts speak for themselves as to why.

Where do our tax dollars go?

Revenue @ 2.4 Trillion		Expenses @ 3.7 Trillion	
Individual Income Tax	47%	Medicare/Medicaid 21 %	21%
Social Insurance Tax	36%	Social Security	20%
Other (fees / duties)	9%	Defense	20%
Corporate Income Tax	8%	Discretionary	18%
		Unemployment Ins.	15%
		Interest	6%

Unfortunately, our current annual deficit of $1.3 Trillion is not rare! Expenses have exceeded revenue in 42 of the last 47 years. Can you imagine any institution or business staying in business with that record? Entitlement spending represents 56% of all expenses and that is up 25% from 40 years ago. Compare that spending increase with the following: Defense spending over the past 40 years has decreased to 20% from 42%, while discretionary spending (infrastructure, research, education, science and technology) has decreased from 26% to 18%. Entitlements now represent $2.0 Trillion of our $3.7 Trillion in expenses, and represent 82% of all current tax revenues. It will not be long (2026) until entitlement represents 100% of all tax revenues as currently structured and codified. While 80% of Americans surveyed are concerned about this projection, 69% and 78% respectively do not want any changes to Medicaid and Medicare. That is also the message that all elected members of Congress go to work with every day.

This spending problem did not occur overnight, but the rate of growth is startling. Expenses of $3.6 Trillion have grown 131% over the past 15 years while revenue has grown only 59%, and the largest expense growth over the same time period was for entitlements +145% and our largest revenue driver, personal income tax, grew by 66% over the same period. The message is clear: we have an expense line item out of control, and our only dominant revenue source, income tax, has not and cannot compete with this expense growth. Any business person can analyze this quickly, and it would not take 15 years to do it. Over time, if you spend more than you make and your balance sheet becomes insufficient, no one will lend to you and you will be out of business. Our current gap between revenue and expense is the highest in the past 110 years and, even with the recently passed tax legislation, will grow worse each year.

More bad news. It is not just our current year deficit that adds to the pile. It is also our unfunded liabilities for the future, that result from promising too much and paying too little, that accelerate the issue and today represent $31 Trillion dollars, all of which is associated with future payments of Social Security, Medicare and Medicaid liabilities.

While we spend more in health care benefits, we don't live longer than others who spend much less per capita. More people receive benefits, however, while fewer are paying taxes, (current data reveals only 49% of households paid federal income tax—and remember that federal income tax payments represent 47% of all tax revenue). Additionally, for those who do pay taxes our current code allows for tax deductions, which number 17 in categories large enough to account for $1.0 Trillion dollars annually. Some of these could be categorized as savings and some as investment, but the reality is they are very costly and must be in the

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Commentary, continued

conversation of tax reform.

If you are still with me, you are likely very depressed and I owe you some options for solutions. They are simple in concept but get really messy in the nitty gritty of real life, vested interests, selfishness, individual and collective irresponsibility, as well as greed.

1. Congress and the President must be more realistic on revenue. Current tax revenue structure is not sustainable. We eventually, as Margaret Thatcher warned, will run out of wealthy people to tax and this most recent legislation could not represent that any clearer. CBO projects the total revenue impact in 2013 of the tax increases for the top 1% will raise but $40.0 billion for an estimated $1.3 Trillion deficit.
2. Tax Reform must be a part of the equation. We must examine how we spend money and raise awareness that tax exemptions are an expense. How do we spend that money and what is the benefit? A $1.0 Trillion expense item in a $3.6 Trillion annual budget cannot be ignored.
3. Entitlement restructuring must happen. Any reasonable person should be able to understand that line items that represent 82% of all revenues, and are growing at rates nearly 100% higher than the revenue growth rate, cannot be sustained—and hiding that knowledge from those who will one day count upon those benefits is cruel and inhumane.
4. Lastly, as shareholders and revenue producers of this great but financially troubled entity called USA Inc., we must change the condition we are in. Perhaps we can make it our business to make certain that those elected in the 2014 congressional elections be people who are willing to sacrifice their political futures for the truth and fall on the proverbial sword in its defense.

"Perhaps we can make it our business to make certain that those elected in the 2014 congressional elections be people who are willing to sacrifice their political futures for the truth..."

Team Birmingham

Michael F. Odar, CFA
President

As I reflect on our accomplishments in 2012, one that I am particularly proud of is the further development of our fiduciary, trust, and wealth management services in Birmingham, Michigan. For the past six years, the last two from our offices on the corner of Maple and Woodward, Mark Jannott, Senior Vice President and Business Development Officer, has been helping us build our brand and service capabilities in Birmingham and Southeast Michigan. In May of last year, we brought together a talented client-centric team to serve our clients in Birmingham and the surrounding area, as well as assist Mark in his efforts. And since many of you knew we were working on this in 2012, I wanted to make sure you knew the results and why we are excited.

In her role as Trust Relationship Officer, Wendy Linehan manages Personal Trust client relationships and provides services relative to Greenleaf Trust's role as trustee, agent and/or custodian. Prior to joining us, Wendy was Vice President, Director of Private Bank Sales at Fifth Third Bank, where she oversaw a team of wealth management advisors, an insurance specialist and licensed sales assistant. She practiced law for 16 years in the areas of probate and trust litigation, complex probate and trust administration, preparation of estate, fiduciary and gift tax returns, and drafting estate planning and business succession documents. Wendy earned both her BA and JD law degree from the University of Michigan and is an accredited holder of the Certified Trust and Financial Advisor (CTFA) designation.

In his role as Wealth Management Advisor, Steve Christensen is responsible for the creation and implementation of wealth management plans, portfolio management, regularly scheduled portfolio review meetings, and coordination with other advisors of the client. Prior to joining Greenleaf Trust, Steve spent eleven years at J.P. Morgan, most recently as Vice President, Banker Associate in the Private Wealth Management Division. He was responsible for the management of client relationships across the bank's deposit, credit, investment and fiduciary accounts. Prior to that, Steve worked as Vice President, Fiduciary Officer in the Private Wealth Management Division, and also as a Trust Advisor within the Private Client Services Division. He earned his BA from Michigan State University, Eli Broad College of Business, and his MBA from Oakland University. He is also an accredited holder of the CTFA designation.

In her role as Team Service Coordinator, Julie Weston is responsible for providing comprehensive support and administrative assistance within the personal trust area. Julie has over seven years of experience in teaching and client service. She has her Bachelor of Arts from Western Michigan University, and her Master of Science in Education from Walden University.

What is very gratifying to me as a result of this accomplishment is the knowledge that all of our clients will benefit from the addition of these new team members regardless of location. Because of our team-based approach to decision making, we have in fact already been able to leverage this team's past experiences and expertise to help clients from all over. And as we continue to grow, this will continue to be our focus.

Retirement Plans – Reflecting on 2012 and Looking Forward

N. Dean MacVicar, CTFA
Executive Vice President
Director, Retirement Plan Division

2012 will likely be remembered as the year of disclosure in the world of retirement plans.

New fee and investment disclosures required by the Department of Labor were provided to plan sponsors or other plan fiduciaries by "covered service providers" such as Greenleaf Trust, followed by DOL-mandated disclosures to participants of retirement plans with participant-directed investment features. Surveys conducted nationally seem to indicate that there has been little reaction to the covered service provider disclosures and the participant fee disclosures, leading one to question whether the disclosures had the overall impact desired by the DOL. That said, we have always fully embraced transparency and full fee disclosure, and we believe the additional information provided to plan sponsors and plan participants will be beneficial.

> "Surveys conducted nationally seem to indicate that there has been little reaction to the... disclosures, leading one to question whether the disclosures had the overall impact desired by the DOL."

In the area of plan design, some of the same trends experienced in recent years continued in 2012. The use of auto-enrollment features and auto-escalation features in 401(k) plans continue to become more popular. And, target-date retirement funds continue to be the most common default investment option in participant-directed plans. On a related issue, we continue to anticipate the requirement for a greater level of education and disclosure relating to target-date retirement funds that are used extensively in plans with participant-directed investment features. These requirements may come from the Securities and Exchange Commission, the Department of Labor or both.

The number of plans offering Roth contribution features continues to grow. Survey results recently published in Plan Sponsor magazine indicate that nearly half of the 401(k) and 403(b) plan respondents include Roth features in their plans.

As we turn our sights forward, we believe there will continue to be an increased focus on good plan governance and on participant services. It will remain important for plan sponsors to both understand and monitor the investment options offered under plans they sponsor. We use the due diligence and mutual fund analysis by our Research Analyst Team, and the corresponding "Mutual Fund Due Diligence Report," as the means of assisting clients in meeting their fiduciary responsibilities in the area of fund selection and monitoring.

Monitoring investments and

understanding fees and expenses are only two areas falling under the umbrella of good governance. More broadly, good governance begins with the recognition that retirement plan administration is something to be taken seriously, and it is important to assure that good processes and controls are in place for all aspects of plan administration, including processing of contributions, participant education and communication, reporting and disclosure, and addressing participant requests and inquiries.

We have written in the past about the importance of employers and service providers assisting employees to plan for a financially-secure retirement. Some feel it is not merely important, but it is an obligation employers have to their employees. The importance of individuals taking responsibility for their retirement and financial security cannot be overstated. Along those lines, whether in a plan sponsor role or a plan service-provider role, we must do all we can to more actively engage participants in planning for their future … becoming engaged in the process at an early time, saving more, investing prudently, managing retirement plan withdrawals wisely, etc. We will continue to focus our efforts on assisting employers in fulfilling their fiduciary responsibilities and assisting participants in the monumental task of building financial security for the future.

And finally, what would an end-of-year article be without a comment or two on the fiscal cliff? As tempting as it might be to comment on the political state of affairs in Washington, I'll limit my comments to only a few matters impacting retirement savings policy. Although few if any look forward to an increase in tax rates, an increase does make retirement savings plans more attractive. The higher tax rates are, the more favorable the tax benefit from saving in a tax-deferred arrangement. That isn't to imply that a continuation of low tax rates should have an impact of detracting from saving; although the tax benefit may not be as attractive, the importance of saving for retirement remains critically important.

An increase in tax rates applicable to dividends and capital gains may also make tax-deferred savings more attractive, even though distributions are taxed at ordinary income tax rates at the time of distribution. On a relative basis during the accumulation period, the tax-deferred arrangement becomes more attractive than under the current low-tax environment.

In closing, best wishes from our entire Retirement Plan Division for a prosperous and productive 2013.

"An increase in tax rates applicable to dividends and capital gains may also make tax-deferred savings more attractive…"

Dave P. Mange, CFA
Vice President
Senior Research Analyst

"For all but the most avid bond market aficionados, 2012 was a fairly routine and boring year in fixed income. Overall index performances in most classes of US bonds were positive despite record low coupon yields because, once again, yields fell, lifting prices."

Fixed Income Watch: 2012 Was Another All-Time Record (Celebration Is Optional)

Bloomberg news reported on December 26, 2012 that the year-long average yield on the 10-year maturity Treasury bond hit an all-time record low at an average of 1.79%. This is good news for tax payers and those who owned bonds all year (without having to put new money to work) and less good news for savers, income investors and those buying bonds lately. As noted in the title, celebration of this milestone is optional.

For all but the most avid bond market aficionados, 2012 was a fairly routine and boring year in fixed income. Overall index performances in most classes of US bonds were positive despite record low coupon yields because, once again, yields fell, lifting prices. The research team at Greenleaf will, as always, carefully watch the bond market in 2013, but we are not expecting a great deal of excitement. The most recent Federal Reserve policy decision, announced on December 12, 2012, puts very clear transparency into the Fed's hopes/wishes/policy; that is, the Fed will keep the only interest rate it directly controls roughly at current levels unless and until unemployment falls to 6.5% or less. Since this is unlikely to happen in 2013, the Fed policy should not change this year. Yet, as we all know, intention and results are not always perfectly correlated.

It is easily possible to imagine a world in which the Fed losses control of interest rates and the bond market regardless of its policy, though we do not believe that time is yet here. Indeed, the US has been extremely fortunate in that while we have expanded the national debt rapidly while inching out of the recession of 2008-2009, the interest rate on that debt has fallen to unprecedented levels. More ominously, however, the record low of 1.38% was reached in July of 2012. Today's 10-year maturity yield stands (perhaps at the low rate we could say "sits?") at 1.72%.

Of the $16.3 trillion dollar national debt, foreign governments own just over 33%, with China and Japan essentially tied for the lead. The Federal Reserve Bank, with $1.6 trillion of Treasury bond assets surpassed both countries to become the largest holder of US Treasury debt on the planet. There is little worry in the short run that any major holders will become significant sellers, though

China has reduced its holdings by approximately 8% over the past year.

It is easy to get lost in the details cited above and lose sight of a larger principle that will one day bring a more usual balance to the bond market. Going back well over 80 years of data, Ibbotson reports that the average yield on the US government bond index has provided a yield between 2.0% to 2.5% over the rate of inflation. This makes elegant logical sense; investors would normally demand some "real" inflation adjusted compensation for making term investments in bonds rather than holding cash.

Another way to state this is that generations of investors have demanded a positive return on their bond market investors.

Today, the "real" inflation-adjusted return on the 10-year Treasury bond is essentially zero. This might continue for a considerable time, but it will not hold forever. Using the Federal Open Market Committee's own forecasts for 2014 (our source is Bloomberg, and the Fed provides the same information and more at www.federalreserve.gov) we find that the Fed forecasts an inflation rate (CPI) of 1.80% in 2014 and an unemployment rate of 7.05%. This unemployment rate would mean that the Fed sticks to its stated policy of holding the inter-bank overnight borrowing rate "at or near zero percent" under those conditions. Using the long-term average real yield on the 10-year bond, the yield should rise to approximately 4% using the Fed's own projections. It likely will not do so, however, because the confluence of forces holding yields down today will not fully abate over the next two years. These forces, perhaps in order of magnitude are: The Fed's expansion of its balance sheet and its role in buying most of the incremental supply of Treasury bonds, a lingering fear of equities as a residual of the 2008-2009 market crash and, finally, an aging population in the developed world that might prefer to hold a higher percentage of fixed income assets than equity assets compared with aggregate preferences of the investing public over the past 80 years. If any of these factors can be said to explain the apparent anomaly of non-existent inflation adjusted yields, the influence of the Federal Reserve is likely the dominant cause by far.

"Today, the 'real' inflation-adjusted return on the 10-year Treasury bond is essentially zero. This might continue for a considerable time, but it will not hold forever."

James W. Gray, CFA
Executive Vice President
Director, Wealth Management

"Looking back over 2012, there are numerous situations that remind us of our team's extraordinary dedication and commitment to our clients' overall financial well-being."

More Than Just An Asset Manager

To the casual observer, Greenleaf Trust is all about managing assets within the context of the financial markets. But, as Dan Rinzema discussed last month, we are dedicated to applying a different, more impactful lens to managing client wealth—the lens of goals-based wealth management (See *Goals-Based Wealth Management: Aligning Life and Wealth*, December 2012). This, coupled with the strong level of service and focus, is what will truly make an impact for our clients over the long term.

Looking back over 2012, there are numerous situations that remind us of our team's extraordinary dedication and commitment to our clients' overall financial well-being. Of the many areas of which I am very proud of Greenleaf Trust, this is one of the greatest.

The following are examples of goals-based wealth management in action. These are very instructional in seeing how we operate in the best interest of our clients in the context of managing overall wealth.

During a mid-summer Trust Committee review we heard a Trust Officer discuss her level of commitment to a family by counseling (at the approval of the matriarch) a college-aged grandchild in the area of choosing a college major, and how the grandchild's decisions could affect other beneficiaries of the family's trust. In this case, the trusted family advisor was involved in a very sensitive family discussion and acted as a voice of reason from outside the family boundaries. The result was a favorable reception by the grandchild, much to the appreciation of the family.

As we develop deep relationships with clients and their long-standing tax advisors, the impact can be substantial. Recently, a client-centric team worked with a client's tax counsel to develop a strategy to derive benefit from substantial tax loss carry-forwards generated from outside real estate activity. The action was to convert a sizeable traditional IRA to a Roth IRA with no tax cost impact to the client. In this situation the tax advisor had provided a great deal of insight into the client's tax situation which was then leveraged in the plan for tax savings. Once the Greenleaf team developed this approach, it was communicated to the client's tax advisor and we collaborated in the adoption and execution of the plan.

In a third situation, a client had a large pending liability outflow expected to be paid five years out. As a result, this liability was weighing heavily on the client's mind, even though the client possessed adequate assets to more than cover this liability exposure. Again, because of the relationship and the level of depth and thoroughness, the Greenleaf Trust client-centric team was able to identify this concern and develop a strategy to effectively immunize this exposure. While we were not able to just make this situation go away, the effect was to resolve this in the client's mind, as opposed to the client being bothered by it over the coming years.

These opportunities for us to act did not just arise, rather they were the result of intentional effort and focus in our deep approach to the handling of our clients' overall wealth profile. These examples are an indication of our level of engagement and caring for each client and family we serve. Certainly, we are deliberate with our policy-driven approach to deliver investment results, but we are (and must be) much more than this to our clients.

The result is peace of mind and confidence that Greenleaf Trust cares and has the expertise and sophistication to focus and drive a significant level of impact for each of our clients. As always, we are honored to have this privilege and opportunity.

"Certainly, we are deliberate with our policy-driven approach to deliver investment results, but we are (and must be) much more than this to our clients."

Making Behavioral Biases Work

Dan J. Rinzema CFA, CFP®
Vice President
Assistant Director, Wealth Management

According to Warren Buffett, "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework." The father of value investing, Benjamin Graham, would take it one step further and can be paraphrased as saying: the investor's chief problem—and even his worst enemy—is likely to be his own bias. Buffett and Graham, two of the most influential investment minds of the 20th century, recognize the pitfalls that accompany emotional and behavioral biases on investment results. They understand that investors have never been fully rational beings as defined by classical economic and financial schools of thought, solely basing decisions on risk and expected return. Instead, investment behavior is often influenced by the biases that are embedded in the human psyche, which when unrecognized by an investor, can be quite damaging to investment returns. Understanding these natural human tendencies, including, among others, anchoring, overconfidence, and mental accounting allows an investor to not only protect their portfolio, but to also make their behavioral biases work for the portfolio's benefit.

> "... investment behavior is often influenced by the biases that are embedded in the human psyche..."

Anchoring

In his recent book, *Thinking Fast and Slow*, Daniel Kahneman, a Nobel Prize winner in Economic Sciences, takes readers on an exploration of the psychology behind decision making. He delves into several behavioral biases that occur without conscious thought. One such bias is that of anchoring, which is the natural tendency to focus on irrelevant information when making decisions. Kahneman measures the effect of anchoring through experiments in which two groups of participants are asked a pair of questions with a different "anchor" in the first question. For example, participants in one of his experiments were asked:

Is the height of the tallest redwood tree more or less than 1,200 feet?
What is your best guess about the height of the tallest redwood tree?

The anchor in the above question set was set at 1,200 feet for the first group of participants and altered to a much lower anchor of only 180 feet for the second group of participants. What Kahneman found was that the two groups produced very different estimates for the tallest redwood tree (844 feet versus 282 feet) depending on which anchor was presented in the first question. Kahneman showed that in many different laboratory and real life situations, people consistently and unknowingly anchor onto irrelevant information during the decision making process.

Anchoring may be easy to demonstrate, but it has proven hard to eliminate from an investment perspective. Have you ever wondered why some investors never sell losing investments, even when there is no sign of growth potential in sight? Anchoring is most likely to blame, as investors tend to anchor onto the price at which they purchased a stock and wait to sell that stock until they can get "back-to-even." This is despite the fact that an investor's cost basis in a security is all but irrelevant when it comes to determining an asset's future growth potential.

Like an anchored ship that cannot float too far away from its tether, investors tend to stick close to the references with which they feel most comfortable. Therefore, to make this well-known behavioral bias work for a portfolio's benefit, investors need to intentionally select the anchor to which they are tethered. Just as a skilled negotiator starts from a pre-determined reference point to frame the negotiation, successful investors start with a comprehensive and holistic wealth management plan. By anchoring to a goals-based wealth management strategy that defines success as achieving personal financial objectives, the behavioral bias of anchoring can serve to keep the portfolio on track, never straying too far from the pre-determined course.

> "Like an anchored ship that cannot float too far away from its tether, investors tend to stick close to the references with which they feel most comfortable."

Overconfidence

Overconfidence is another great example of irrational behavior that can damage portfolios and hurt returns. It is a natural tendency to overestimate one's own abilities. For instance, studies show that 80% of people believe that they are better-than-average drivers, and 70% of Americans believe that they are more intelligent than the average American. From an investment perspective, a study entitled The Quantitative Analysis of Investor Behavior revealed that over the 20 year period ending December 2011, the average investor trailed the broader market by as much as 7% annually. Consistently poor relative performance is attributed to psychological factors like overconfidence as it leads to an increase in self-destructive behaviors, including frequent trading and holding concentrated positions.

Adherence to a long-term wealth management plan that emphasizes strategic diversification and downside scenario stress testing can keep overconfidence from negatively affecting a portfolio. Goals-based wealth management also lessens the urge to speculate since achieving long-term objectives, versus beating short-term markets, becomes the over-riding charge. Prudent planning, including a customized investment policy statement, has proven successful in combating the emotional pitfalls and behavioral biases that detract from returns.

Mental Accounting

Perhaps the most prevalent behavioral bias is that of mental accounting. It is the brain's tendency to classify items and activities into separate categories or accounts. Research shows that the majority of us engage in mental accounting on a daily basis. We are compelled to go out of our way to save $100 on a flat screen TV, but the same $100 savings would be irrelevant in our decision to purchase a home. These contradictory judgments violate an important principle of economics, which assumes that money is interchangeable. The brain, however, engages in mental accounting, so we end up treating our dollars very differently based upon the context in which they are viewed.

> "Acknowledging and understanding this bias in the context of investment management opens the door to not only overcoming it, but also making it work in the portfolio's favor."

Take me, for example. My Dutch (read frugal) heritage typically prevents me from parting with $4 on a daily cup of Starbucks coffee. However, my credit card's cash-back rewards program allows me to select a Starbucks gift card in lieu of cash, which I gladly use to indulge in caffeinated goodness. Of course, this is terribly inconsistent behavior. The economic value is the same in each scenario, but due to the common behavioral bias of mental accounting, dollars from a cash-back rewards program seem somehow different than the rest of the dollars in my pocket.

Acknowledging and understanding this bias in the context of investment management opens the door to not only overcoming it, but also making it work in the portfolio's favor. For instance, an investor recently came to Greenleaf Trust whose portfolio would soon be required to provide for her lifestyle needs during retirement. It was, however, also intended to satisfy her equally important philanthropic legacy goals. Whenever the market was down, fear of jeopardizing her lifestyle had compelled this investor to sell most of her equity allocation (usually at an inopportune time). Whenever the market was up, fear of not fulfilling her philanthropic vision had compelled her to ratchet up the risk profile of the portfolio to unwarranted levels (usually at an equally inopportune time).

The client-centric team that served on behalf of this client recognized that fear was the primary emotion causing financial anxiety. Fear of experiencing negative returns and fear of missing out on a market run had, in turn, led to the roller-coaster ride in equity allocation and the accompanying poor historical return results. The team instituted a long-term wealth management plan, which among other things appealed to mental accounting to remove emotion and stay the course. They determined the amount of the portfolio that would be required to sustainably support the client's lifestyle needs with a high degree of certainty and invested these funds in a more conservative manner. The remaining funds were invested in a more aggressive fashion to position this portion of the portfolio for long-term growth consistent with the desire to maximize a philanthropic legacy. The technique of mental accounting now serves as the psychological framework through which turbulent markets can be more easily weathered. The client has the financial peace of mind knowing that her shorter-term lifestyle needs will be met regardless of market volatility, and her longer-term philanthropic desires have the necessary time horizon to benefit from short-term market fluctuations.

Conclusion

Recognizing and understanding the behavioral biases that are embedded in each of us is not only the first step to overcome them, but to also make them work for the portfolio's benefit. Anchoring, overconfidence, and mental accounting are only the tip of the iceberg, but luckily the remedy to negate behavioral biases in general is the same—prudent financial planning. A comprehensive goals-based wealth management plan can sidestep the emotional and behavioral pitfalls that Buffett and Graham warn about, and set the foundation for lasting financial success.

"A comprehensive goals-based wealth management plan can sidestep the emotional and behavioral pitfalls..."

Stock Market Pulse

Index	12/31/12	% Change Since 12/31/2011
S&P 1500	329.78	16.17%
DJIA	13,104.14	10.16%
NASDAQ	3,019.51	15.91%
S&P 500	1,426.19	16.00%
S&P 400	1,020.43	17.88%
S&P 600	476.57	16.33%
NYSE Composite	8,443.51	12.93%
Dow Jones Utilities	453.09	1.57%
Barclays Aggregate Bond	111.08	3.76%

P/E Multiples	12/31/12
S&P 1500	13.7
DJIA	12.7
NASDAQ	15.5
S&P 500	13.4
S&P 400	16.8
S&P 600	17.9

Key Rates

Fed Funds Rate	0% to 0.25%
Tbill 90 Days	0.11%
T Bond 30 Yr	2.93%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	329.78	13.7x	2.17%
S&P 500	1,426.19	13.4x	2.27%
DJIA	13,104.14	12.7x	2.61%
Dow Jones Utilities	453.09	NA	4.17%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.76%

MAIN OFFICE:
211 South Rose Street
Kalamazoo, MI 49007
office: 269.388.9800
toll free: 800.416.4555

BIRMINGHAM OFFICE:
34977 Woodward Ave., Suite 200
Birmingham, MI 48009
office: 248.530.6202

HOLLAND OFFICE:
150 Central Avenue
Holland, MI 49423
office: 616.494.9020

TRAVERSE CITY OFFICE:
130 South Union Street
Traverse City, MI 49684
office: 231.922.1428

PETOSKEY OFFICE:
406 Bay Street
Petoskey, MI 49770
office: 231.439.5016

GRAND RAPIDS OFFICE:
51 Ionia Avenue SW
Grand Rapids, MI 49503
office: 616.454.0311

GREENLEAF® TRUST

e-mail: trust@greenleaftrust.com
www.greenleaftrust.com

Southeast Michigan
Mark W. Jannott, CTFA
Senior Vice President
Investment & Estate Planning
cell: 248.417.5527

Northern & West Michigan
John F. Welch, CFP®, CTFA
Senior Vice President
Financial & Estate Planning
cell: 231.642.1175

Kalamazoo
Albert Little
Vice President
Business Development Officer
cell: 269.760.0979

Retirement Plan Services
Matthew D. Siel
Vice President
Business Development Officer
cell: 616.540.2093