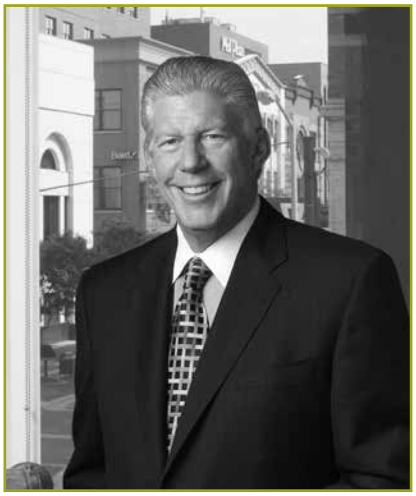
GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

JUNE 2013 VOLUME 22, ISSUE 6



William D. Johnston
Chairman, Greenleaf Trust

Happy Birthday Greenleaf Trust

Beginning in the late 1980s and continuing through the early 1990s, I observed a tremendous consolidation in the banking industry. Large money centered banks were acquiring large regional banks who were gobbling up smaller regional banks who in turn were buying small community banks. The concept was to buy rather than build deposits and then consolidate the back office side to drive greater profitability. The concept was so in vogue that there were stock funds of both the publicly traded mutual fund variety as well as private placement investment vehicles made up solely of bank stocks. It was indeed a hot sector and it had the attention of investors.

Simultaneous to this consolidation was the continued erosion of the Glass-Steagall Act, originally created by Congress to separate the deposit and lending side of financial institutions from the investment banking and syndication side. This legislation for nearly six decades prevented FDIC Institutions from creating non-guaranteed products to sell depositors and allowed depositors to be relatively free from conflicts of interest perpetrated by their "savings or lending" institution. As regulation relaxed, banks began to create their own common investment funds which would become the predecessor to their own mutual funds. Insurance product and brokerage services soon followed as banks attempted to benefit from the entire food chain of investment product fees including investment banking and the syndication of new issues of stock and bond offerings. It was this landscape of consolidation and increasing conflicts of interest that led me to recognize that banks were becoming the same as brokerage firms and insurance companies. The emphasis on selling investment products was obvious and growing as were the risks to depositors. The implications for trust customers were clear. How could banks providing fiduciary services do so without conflicts of interest when they were investing their trust customer's assets in the banks' own proprietary mutual funds? It was in fact this question that led me to believe that the market was ready for and needed to have a trust bank that would offer traditional fiduciary services free of conflicts of interest and free of proprietary products.

With this vision in mind and as President and Founder of Greenleaf Asset Management Company, a Registered Investment Advisory Firm, I began our mission to become one of the very few Michigan Chartered Banks that

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Happy Birthday, continued

delivered only fiduciary and wealth management services and would not offer deposit or lending services. After a long and arduous application and registration process, we received our State of Michigan Bank Charter with Trust Powers in May of 1998 and opened our doors as Greenleaf Trust in July of 1998. This July marks our fifteenth year as a Michigan Chartered Bank and we are celebrating so many wonderful accomplishments that have occurred during that time.

Our industry is often measured by numbers and statistics and while we are certainly proud of our accomplishments reflected in our statistics, we are much more proud of the culture that we have created and enhanced. It is my firm belief that it is our business, workplace and talent culture that has both created and perpetuated our fabulous growth.

Through May of 2013, Greenleaf Trust is honored to serve nearly one thousand client relationships inclusive of nearly three thousand accounts and over twelve thousand participants in our employer sponsored retirement plans. This consistent growth in new clients as well as the retention of existing clients means that we now manage nearly six billion dollars of assets for those we serve. Our growth of assets under management (AUM) as well as assets under custody (AUC) has resulted in a compounded annual growth rate of revenue (CAGR) of 19.8% and a compounded annual growth rate of assets under management of 13.8%. This growth rate is especially rewarding when viewed against industry comparables of 3.1% and 1.3% respectively. While we are pleased with our growth performance we are even more pleased with the continued strengthening and developing of our core business, workplace and talent culture. It is in fact, the combination of those components of the Greenleaf Trust culture that explains our success.

"…while we are certainly proud of our accomplishments reflected in our statistics, we are much more proud of the culture that we have created and enhanced."

I have always believed that companies with great cultures succeed more than others. It is also my firm belief that companies that value and defend their culture will have more consistent success than others. Our business culture is simple and client focused and described as follows:

1) We are on the client side of the desk always and without exception. We have no conflicts of interest, ever.
2) We have nothing to sell, only service to deliver. We will never have any proprietary products.
3) We deliver our service in a team method thereby providing our clients the collective talent, skills, education and wisdom of our entire team.
4) We serve our clients with a focus on continuous improvement. Simply put, our efforts of today are not good enough for tomorrow. We are committed to improvement and have structured our processes to assure it is in our collective corporate DNA.
5) Our budget is resourced and developed to meet our continuous improvement needs. The priorities of our budget are simple, our clients are first, our employees next and shareholders last.

6) Trust is not only in our name, it is what we do. 81% of our income is derived from managing and administering irrevocable trust instruments while another 17% of our revenue results from serving as trustee, administrator and manager of employer sponsored retirement plans. We are committed to delivering fiduciary excellence in all we do at the highest standard possible.
7) Confidentiality is of the highest order. Each Greenleaf Trust team member is committed to the principles of being honest and honorable. It is a line in the sand which can never be crossed and never tolerated. If we make a mistake we make it right and we make it right, right away.

A great business culture can only be delivered with a great team. We began our journey fifteen years ago with a team of seven very experienced trust professionals accompanied by an asset management company of five investment professionals. Together this team of twelve began our company's march forward, focusing on our vision of creating a fiduciary business around the pillars of our core culture and with the mission that we were to provide financial security for generations to come and, in fact, into perpetuity. In 2002, we merged Greenleaf Asset Management with Greenleaf Trust forming one leadership team, directed by one Board of Directors and regulated by one regulatory agency. The sixteen team members that joined together in 2002 as one entity now number 82 and by the completion of 2013 will grow to 86 talented individuals focused on our clients, vision, mission and culture.

"A great business culture can only be delivered with a great team."

To perform for our clients at the highest benchmarks of fiduciary and investment management services possible, I believed we must be a talent based organization. A company that understands talents required and only selects team members that possess the required talents. Today, I would rank our talent with any competitor in our industry. Our journey of literacy in understanding talent alignment has grown and matured over the years as has our understanding of coaching and leading highly talented individuals. I am very pleased that nearly all of our executive leadership team has developed within Greenleaf Trust and that our new President, Michael Odar, is not only a fourteen-year veteran of Greenleaf Trust but has grown and developed through multiple divisional leadership opportunities over his career. We have truly amazing team members being led by fabulous members of our executive leadership team who are being supported and challenged by a wonderfully competent and experienced Board of Directors.

The recruitment, development and retention of great talent can best be accomplished through the creation of a great workplace culture, one that is inspired and engaged every day. The creation of this culture is intentional and by design and not by accident. Talented high performing and highly accountable people want to work with people just like them and are energized by their presence. A talented workforce wants opportunities for growth and seeks

Happy Birthday, continued

companies that care about their individual growth while also resourcing their roles to provide them the best opportunity to be impactful in their individual and corporate missions.

"Every other year we produce detailed surveys for our clients to complete and we are always eager for the results… because we want to know what we must do better."

It is common to hear various companies state that we can't improve what we can't or don't measure. We not only believe this axiom, we deliver on it. Every other year we produce detailed surveys for our clients to complete and we are always eager for the results. Not because we want to hear glowing things about our company (we do!) but because we want to know what we must do better. We also annually survey our team members in an anonymous third party survey instrument to determine how they feel about their role and those that lead them in their role. We utilize the results of all of our survey instruments for our corporate planning and continuous improvement. I am both honored and humbled to say that the results of these surveys as well as our client retention, new business data and employee satisfaction and engagement results affirm that we are on the right track. During 2012 and again in 2013, Greenleaf Trust received recognition as one of the 101 Best and Brightest Companies to work for. Those awards were at the Elite level for both Metro Detroit as well as west Michigan. It has been an amazing fifteen years for Greenleaf Trust. We are grateful, honored and humbled to work on behalf of so many wonderful clients. When asked, as I often am, as to why we have achieved the success we have over what has truly been a very turbulent period in our country's and in fact our world's financial history, I simply reply, "the pillars of our core culture differentiate us from our competition as a fiduciary and wealth manager that cares first and foremost about our clients. Secondly we have really good people by design that are talented, engaged and accountable, and third, we value and aspire to build a great work place culture that recruits and retains world class talent." Thank you for allowing me to share our 15th Year Birthday Story, we look forward to many, many more.

Greenleaf's On-Base Percentage

Michael F. Odar, CFA
President

As I have discussed in past articles, data collection and analysis is an important initiative within our 2013 Strategic Plan. Reasons are to make sure we are working as efficiently as possible and delivering on our world-class holistic wealth management value proposition to clients. Probably not too uncommon an objective for many companies, but how do you measure, analyze, and manage efficiency and delivery of service in a trust company? What are the meaningful statistics?

In the 2003 best-selling book *Moneyball: The Art of Winning an Unfair Game*, Michael Lewis describes how the 2002 Oakland Athletics (A's) baseball team used meaningful statistics to build a winning baseball team. Before meaningful statistics the A's, just like every other team, relied on the intuitive expertise of their scouts to identify talent. Envision cigar chomping men sitting in the stands in loud blazers and fedoras. Scouts would typically focus on the physical attributes of players as well as their batting averages to gauge how productive the player would be for their team. By productive, I mean how many runs they would score because in baseball, the team with the most runs wins the game. Batting averages are calculated by dividing the number of hits a player gets by his number of official at bats. After a proper statistical analysis, the A's found that a player's ability to get on base was a much better predictor of how many runs he would score. And, the team with the most runs at the end of the game wins.

If we deliver world class holistic wealth management, the result should be client satisfaction. Therefore, if we define Greenleaf's objective as client satisfaction, we next need to determine what factors will help us achieve that objective. We need measurable statistics that reliably reveal cause and effect. Measurable statistics for client satisfaction do exist; however, what might be satisfying to one client may not necessarily be satisfying to another. This is the main reason why our approach with each client is customized to their needs. To create that customization, Greenleaf team members need purposeful time with and for each client. We know from surveys and discussions with clients that they value this intentional personal quality service. One way we measure time spent with and for each client is to count personal meaningful touches. In other words, meetings, phone calls, directed written communication (not a mass mailing), interaction outside the office, etc. These personal meaningful touches are the actions that create the customization outcome, which leads to client satisfaction. They are one of our many meaningful statistics or more commonly referred to as key performance indicators that we continuously measure, analyze, and manage.

Key performance indicators provide us with the information we need to make sure we are doing what our clients need us to do.

"...how do you measure, analyze, and manage efficiency and delivery of service in a trust company? What are the meaningful statistics?"

James W. Gray, CFA
Executive Vice President,
Director of Client Centric Team Division and Research

“... many investors fall prey to the extrapolation of recent market behaviors. They often assume that the prevailing market conditions will likely continue into the foreseeable future...”

Alternative Asset Classes

As Dave Mange discussed in his May 2013 *Perspectives* article, “there are no magic asset classes.” His article covered the use of a floating rate high income fund as one approach to increasing yield in client fixed income portfolios without adding material credit risk or increasing duration (interest rate) risk. As of this writing, the S&P 500 is up 15.5% year-to-date and the Dow Jones Industrial Average is up 16.7%, while the 10-year treasury is yielding a paltry 2%. It is times like these that many investors wish they had pursued an equity-only strategy versus experiencing the drag that recently accompanied the other asset classes that characterize a properly diversified portfolio (i.e. fixed income, alternatives, and cash equivalents). While the benefit of hindsight can create unhealthy biases, equally troublesome is the fact that many investors fall prey to the extrapolation of recent market behaviors. They often assume that the prevailing market conditions will likely continue into the foreseeable future and position their investments accordingly. However, prudent investment management, which is focused on achieving an investor’s unique financial goals over the long run, dictates that portfolio construction be designed not just for a single environment, but rather for a variety of divergent economic and market conditions.

Alternatives have come to prominence over the last decade as investors have lived through two significant bear markets in equities and interest rates have declined steadily, potentially making future fixed income returns unattractive. Investors want higher returns than bonds currently offer, but with less volatility than equities. While there is no free lunch and no guarantees, we believe a select few alternatives can occupy that space between stocks and bonds in terms of return profile and volatility.

For our purposes, alternatives refer to any asset class outside of long-only publicly-traded equities, fixed income, and cash equivalents or money market funds. Traditional equities include individual stocks, as well as mutual funds and exchange-traded funds that are used selectively in portfolios, and fixed income includes high-yield bonds and emerging market debt. Thus, the alternatives category includes among others real estate, commodities (including oil, natural gas and precious metals), private equity, venture capital, hedge funds and other very specific strategies. Each of these has subsidiary components with assets and strategies that vary widely and that span the liquidity spectrum.

When evaluating alternative investment classes, Greenleaf Trust’s Research Team holds to the following four criteria in order to recommend an investment be deployed within client portfolios:

1) Purchasing power (or inflation) protection
2) Low correlation to equities
3) Attractive volatility-adjusted returns

4) Long-term returns greater than bonds

It seems every week Wall Street is coming out with a new alternative investment product that is the "next big thing," promising equity-like returns with lower risk (who wouldn't want that?). While there are now a myriad of alternative investment products available to the public, our research shows that many offer poor long-term risk-adjusted returns and are more speculative bets than good investments. In addition, alternatives may not necessarily provide meaningful protection in extreme down markets, such as experienced in 2008. However, there are several alternatives that we believe can play a role in enhancing returns and reducing volatility, which is particularly true at the present time given the precariousness of the fixed income market in general.

We are currently constructive on three liquid vehicles within the alternatives space: Managed Futures, Real Estate Investment Trusts (REITs) and Merger Arbitrage strategies. These instruments have been assessed in light of the four point selection criteria articulated above:

- Managed Futures is a macro-based trend-following strategy that uses futures contracts to capitalize on market trends on a broad variety of assets including equities, bonds, interest rates, commodities and currencies.
- Merger Arbitrage Funds exploit volatility in securities with underlying companies involved in mergers and acquisitions to generate returns. While their expected return is less than managed futures, they also have lower volatility and still offer a very low correlation to equities.
- Equity REITs invest directly in real estate and earn income through property rents while mortgage REITs own property mortgages, often through mortgage-backed securities, and earn income through interest in loans. Over the long term, the vast majority of returns on REITs are driven by their dividends.

We recently exited a small commodities position within most client portfolios. We employed commodities as an alternative asset for its exposure to a broad basket of commodities including energy, agriculture, industrial and precious metals. Our recent deep review of the commodities space suggests a poor record of inflation protection and increased correlation to equities in the most challenging market scenarios. Furthermore, future returns are dependent on price increases, and while world population is increasing, raising the demand for commodities, suppliers are also becoming more efficient in producing those commodities, which has an offsetting impact on price over the long term. For these reasons, we do not currently recommend exposure to commodities.

While alternatives may not be as

"Our recent deep review of the commodities space suggests a poor record of inflation protection and increased correlation to equities in the most challenging market scenarios."

Alternative Asset Classes, continued

"Using quantitative modeling tools, we have determined that most optimal investment portfolios... should include alternative investments..."

necessary when interest rates rise and bonds offer higher returns, they are certainly applicable in today's environment. In general, alternatives have historically generated returns and volatility below publicly-traded equities, but above current expected fixed income returns. While some alternatives provide strong returns (e.g. REIT's provided close to a 30% return over the last twelve months) as a whole, they do not offer truly "equity-like" returns. Using quantitative modeling tools, we have determined that most optimal investment portfolios across the return/volatility spectrum, except for those with the highest return targets, should include alternative investments, and we recommend an allocation of up to 15% of total investable assets. We expect this allocation will nominally improve returns and more importantly lower volatility relative to a portfolio without alternatives.

Normally, an asset allocation to bonds allows portfolio construction to meet the needs of a variety of investors with different risk preferences. Today, however, the record low yields on investment grade bonds, while still critical, make this asset class less compelling when building portfolios. With only one leg of the traditional three asset class stool offering a historically normal risk/return profile, an allocation to alternative assets can be helpful. Our research shows that the amount of alternative assets in a portfolio is highly dependent on the assumed yield for fixed income. In other words, the optimal allocation to alternative assets in 2013 should be expected to be higher than that allocation might be if/when bonds return to their normally expected premium yield to inflation. As fixed income returns rise, the use of alternative assets may be reduced.

Overall, we continue to monitor the ever-changing landscape for additional investment instruments to serve the financial needs of our clients. Our Research Team continues to monitor the economic and market environments and each of the asset classes listed above. Over time and as market and interest rate conditions change, it is likely that the investments deployed in the prudent construction of portfolios will also shift in conjunction with the changing environment.

If you'd like to join us in our efforts to conserve natural resources and create a greener environment, you may choose to save paper by receiving email notifications to view your statement online. Simply give us a call at 269.388.9800 and ask to speak with a member of your client centric team.

Have You a Retirement Age In Mind?

Lorey L. Matties
Participant Services Coordinator

What is your plan for retirement? Do you have a specific retirement age in mind or are you focusing on a target dollar amount to have saved? The more planning and saving you do today will ensure that you have more choices for your retirement.

A new Gallup poll discovered that three in four employed adults in the U.S. today are planning to work past their normal retirement age, with 40% saying it is because they want to. A much smaller percentage at 19% fit the typical retirement scenario of someone who plans to stop working at retirement age by choice and 35% say they will continue to work for financial reasons.

More Opting for Part-Time Work Post-Retirement

The poll found the number of employed adults that plan to work part-time, past normal retirement age, varies greatly from those working full-time. It is interesting to note that many want to continue to work based upon choice rather than by necessity. Where do you fall on this chart? Will you have the option of choice?.

	Results Out of 100 %
Continue working -- full-time	15
Want to	6
Will have to	9
Continue working -- part-time	61
Want to	34
Will have to	26
Unspecified	1
Stop working entirely	22
Want to	19
Will have to	3
No opinion	1

GALLUP® April 4-14, 2013

“Do you have a specific retirement age in mind or are you focusing on a target dollar amount to have saved?”

High-Income Americans Most Open to Working Post-Retirement

The poll found that men under age 35 are slightly more likely than their counterparts to say they want to, rather than need to, continue working past retirement age. However, there are bigger differences by household income, with those earning $75,000 or more being most likely to remain in the workforce.

Overall, about three-quarters of upper-income Americans as well as those earning less than $75,000 annually intend to work past retirement. However, for those already earning a comfortable living, it is more of a

Retirement Age, continued

choice than a necessity. That is evident in the finding that nearly half of those earning $75,000 or more say they plan to work past retirement because they want to. That compares with roughly a third of adults in lower income categories.

	Continue Working By Choice %	Continue Working By Necessity %	Stop Working By Choice %
U.S. employees	40	35	19
Men	43	31	20
Women	36	38	17
18 to 34 years	46	30	20
35 to 54 years	36	39	18
55 and over	41	32	19
$75,000 and over	49	26	22
$30,000-$74,999	35	39	19
Less than $30,000	32	43	15

GALLUP® April 4-14, 2013

"We believe that retirement education is a key employee benefit."

As you may expect, the same poll found that middle and lower-income Americans are more likely than upper-income Americans to say part-time work will be a major source of income for them in their retirement.

Potential Long Term Advantages

"Retirement once represented a lifestyle free from the demands of work, but also reliance on personal savings and Social Security." Both of those impressions may change if Americans carry through on their intent to continue working, at least part-time, after reaching retirement age. While this could be a disappointment for certain retirees, it could have benefits both socially and health-wise for Americans, if staying in the workforce keeps seniors more physically and mentally active than they would be otherwise. It would clearly assist them financially, particularly if the alternative is dependency on inadequate retirement savings and an uncertain Social Security system. This, in turn, could benefit the economy, with seniors contributing experienced labor as well as earning income that fuels consumer spending and, the economy as a whole.

We believe that retirement education is a key employee benefit. Our Participant Services Coordinators are committed to providing our plan participants with the necessary knowledge and understanding to secure a financially secure retirement.

For more details on Gallup's polling methodology, visit www.gallup.com.

Keeping Real Estate in the Family… New Law May Provide a Solution

Lauree Kosobucki, CFTA
Trust Relationship Officer

On December 27, 2012, Governor Snyder signed House Bill 4753, which amended the General Property Tax Act (GPTA) to allow real estate owners to transfer property between family members without uncapping the property tax. The amendment becomes effective on December 31, 2013, and states a transfer of ownership does not include a transfer of residential real property if the transferee is related to the transferor by blood or affinity to the first degree and the use of the residential property does not change following the transfer.

Real estate is often one of the larger assets owned in one's estate. Many families not only have a primary residence but also own a second home or vacation retreat. In several cases, these properties have been in the family for years. Often the goal of the original owner is to keep the property in the family and transfer the asset to the next generation.

Succession planning for determining the most effective method of accomplishing this goal can be critical because of many tax and non-tax related transfer issues. One of the biggest hurdles is to decide how to transfer the property without uncapping the real estate taxes.

The new law appears to address the transfer tax issue and at first glance, it would seem to be a possible solution for many families. However, the law fails to address transfers to trusts, estates or limited liability companies. These entities are often utilized to address many non-tax related issues of a transfer, such as future management and liability issues, which can often be more concerning than the taxes.

In order to fully understand the importance of this amendment and why "uncapping" the property tax is such a concern, we need to look back to 1994 when Proposal A (P.A. 415 of 1994) was put into law. Proposal A was adopted by Michigan voters on March 15, 1994, and is in part, a proposal to increase sales tax and reduce property taxes. The law changed the way property taxes are calculated in Michigan by using what is called the "taxable value".

Prior to 1994, property taxes were based on the "assessed value" or an amount equal to 50% of the property's market value. This method of calculating taxes resulted in property taxes fluctuating based on an increase or a decrease in property values. Proposal A stabilized this fluctuation by creating a "cap" by which the property tax would be calculated. The change to the law stated that the taxable value could only increase each year by the lesser of 5% or the rate of inflation.

There is an exception to the cap imposed by Proposal A. Once the

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Family Real Estate, continued

"...uncapping the property taxes can... potentially cause financial hardship to the children receiving the asset, forcing them to sell the property."

property is sold or transferred, the cap is lifted and the taxable value is recalculated to equal the assessed value. For property owners that have owned their homes for several years, there could be a substantial difference between the taxable value and the assessed value. Potentially, the lifting of the cap greatly increases the property tax in the following year.

Let's consider a real example. One of our clients, a single woman, solely owns a home on Lake Michigan and is considering how to transfer the home to her only child. In reviewing the ownership, we identified that the current taxable value is $377,261 and the assessed value is $866,700. (Note: the taxable and assessed values are disclosed on the property owner's annual tax bill. Alternatively, you can contact your local tax assessor or go to the taxing authority's web site to obtain these values on your home.)

For this client, the 2012 tax bill was $10,493.85, based on a homestead millage rate of 27.8159 ($377,261 x .0278159). If the property is sold or transferred, the taxable value cap will be removed and the 2013 tax bill will be calculated based on the assessed value. Assuming both the assessed value and homestead millage rate remains the same, the tax will be calculated based on the $866,700 value. The 2013 tax bill would be $24,108.04 ($866,700 x .0278159), which is an increase of $13,614.19. If the child does not elect to have this home as his primary residence, the tax assessor will utilize a non-homestead millage rate of 45.8159, resulting in a tax bill of $39,708.64 for 2013.

As this example reveals, uncapping the property taxes can be a significant issue. The increase in tax can potentially cause financial hardship to the children receiving the asset, forcing them to sell the property. For the above mentioned client, the new law helps to simplify the tax planning aspect of this transfer and appears to offer a solution for them, ultimately saving them over $13,000 in property taxes during the first year alone.

A potential strategy to utilize with the new law is the use of an "enhanced life estate deed," aka Lady Bird Trust. As outlined in an article by Garry Kempker, Trust Relationship Officer at Greenleaf Trust, in the August 2008 issue of *Perspectives*, enhanced life estate deeds allow you to deed your home or other real estate to your beneficiaries now, and reserve for yourself a life estate (i.e. the right to live in the home for the rest of your life). This option may work as long as you deed the property to the first degree relatives by blood or affinity.

In the above example, the family dynamic is simple. However, families with more complex situations, (i.e. multiple children and generations), there can be more questions to consider. The succession planning for this asset will be different for each family and will require a plan that takes into consideration the family goals and unique relationships. In addition to the property tax implications, discussions with your advisors should include other non-property tax related issues including but not limited to:

- Future management of the property (scheduling use of property during peak seasons, determining who is responsible for repairs and maintenance, etc.)
- Right to partition (a tenant in common may force the sale of property at any time for any reason)
- Creditors ability to place lien on the property
- Estate and gift tax consequences of the transfer
- Determining whether the property is an asset your children wish to have
- Financial burden it may cause for the transferee

In summary, this new law may provide you with a solution to keep the family home in the family for generations to come. With six months remaining before it goes into effect, now may be an opportune time to meet with your advisors to discuss the planning opportunity this change provides us. Please seek specific real estate legal advice before making any decision regarding your property.

If you'd like a copy of the August 2008 *Perspectives* article noted above or if you have any questions regarding this new law, please don't hesitate to contact any member of the Greenleaf Trust Team.

THE ENTIRE HOUSE BILL NO. 4753 CAN BE FOUND AT
WWW.LEGISLATURE.MI.GOV/DOCUMENTS/2011-2012/BILLENROLLED/HOUSE/HTM/2011-HNB-4753.HTM

Keeping the Elephants Away

Nicole E. Asher, CFP®, CHFC
Senior Wealth Management Advisor

My friend's dad was always a little peculiar. While driving down the highway he would randomly start honking the horn. When we would ask what he was doing he would reply, "Keeping the elephants away." My friend would say "But Dad, there are no elephants!" To that he would respond, "Exactly!"

Earlier this year, Dan Rinzema warned us about the behavioral biases of anchoring, overconfidence, and mental accounting. Anchoring and mental accounting are information processing cognitive biases and overconfidence is an emotional bias. Other forms of biases are the belief perseverance biases, which include the illusion of control.

The illusion of control bias is the tendency to believe that we can control or influence outcomes when, in effect, we cannot. Like thinking that we can keep the elephants away by honking; when in fact, there are no elephants. The sport of gambling, and the investment arena, frequently involve the illusion of control. In fact, in the game of craps, it has been shown that individuals will actually shake and roll the dice more robustly when they want a higher number to appear. The roller actually believes that they have control over this entirely random act. Ellen Langer, PhD of Harvard University's Psychology

“While having confidence is a positive trait, having an illusion of control can be detrimental when dealing with investments. It can lead investors to have overconfidence.”

Department, defines the illusion of control bias as the “expectancy of a personal success probability inappropriately higher than the objective probability would warrant.” Langer found that choice, task familiarity, competition, and active involvement can all boost our confidence levels and generate these illusions.

While having confidence is a positive trait, having an illusion of control can be detrimental when dealing with investments. It can lead investors to have overconfidence. For example, most successful surgeons are confident individuals. While they may save lives in the operating room, this expertise does not necessarily translate into the investment arena. They can control most situations in the operating room, but they cannot control the stock market. Being in control makes us feel happy. It produces optimism and high self-esteem. Interestingly, research has shown that individuals who suffer from depression are less likely to have illusions of control and actually have a much better grip on reality.

In regards to choice, individuals believe that choice equals control. I have found myself guilty of this illusion of control. While I don’t purchase lottery tickets often, when I do, I usually choose my “lucky” numbers. I am well aware that my choosing “lucky” number will not increase my chances of winning the lottery, yet I still do it. Investors fall into this same trap. They believe that if they choose a stock for their portfolio, versus a broker choosing it for them, that they have more control over the performance of that stock.

Investors also tend to purchase stock in companies that they are familiar with. If we asked individuals on the street which stock they would be more likely to purchase, McDonalds or Biglari Holdings (a diversified holding company that owns the Steak n Shake restaurant chain), most would say that they would purchase McDonalds. If you asked them why, they would likely say that it’s because they have never heard of Biglari. Believing that a company is a better investment because we are familiar with it and assuming that a company is not a good investment because we have never heard of it, is a false illusion. We also don’t want to confuse the familiar with the safe. Look what happened to shareholders of the all too familiar General Motors.

Slot tournaments are common at casinos, but is anyone ever really good at slots? What skills does this competition require other than an ability to push a button or pull the arm on the machine? Unfortunately, many gamblers actually believe that they possess this skill and compete in these tournaments. They often remember the wins and conveniently forget their losses. Individual investors often do the same. They think that they are good stock pickers, because they randomly picked a few winners, but they conveniently forget about the losers they chose along the way.

Illusions of control can also lead investors to hold concentrated positions and undiversified portfolios.

Employees tend to believe that they have control over the stock of the company where they work. No matter what their position may be, they feel that they have an active involvement. An example of this is Enron. Many former employees thought that Enron was the best company they ever worked for. Salaries were above those of their peers and benefits were top-notch. Employees felt well taken care of, they had access to a state of the art gym, refrigerators stocked with soda, and taxis home if you worked past 9pm. At its peak, over 60% of the Enron's 401(k) retirement funds were invested in company stock. A majority of employees banked on the stock for their retirement funds and most were heavily concentrated in company stock. Enron employees tied up significant portions of their net worth in company stock because they knew what an amazing company it was. They felt that if problems arose, they would have sufficient time to exit. Enron employees had an illusion of control that the stock was safer because they worked there — because they felt as if they were actively involved. It is pretty safe to assume that these same employees would not have invested in Enron if they did not work there. Outside investors are less likely to hold concentrated positions in companies where they don't feel this illusion of control. The stock reached a high of $90 and, sadly, later plummeted into bankruptcy. Employees lost not only their jobs but their life savings. Despite the lessons that Enron has provided, this same mistake continues to be repeated many times over by investors.

Active involvement illusions can also be seen in online trading. Typically, the more active an investor is in decision making, the higher their illusion of control. Research has found that online traders believe that they have more control over the outcome of their investments than they actually do. They also believe that the more they trade, the more control they have. What results is excess trading and over time, impaired returns.

Have you ever wondered why our President, Mike Odar, wears bow ties? Rumor has it that the first couple of times Mike wore a bow tie, the stock market spiked up. So Mike believed that his bow ties created market upticks. Before we all go out and buy Mike more bow ties, we need to realize that this is a false illusion of control. Mike's bow tie day correlation with up market days is strictly a coincidence and, of course, is only a rumor. Correlation does not imply causation, yet we all have tendencies to see patterns where no patterns exist.

Illusions of control are exactly that — illusions. We can no easier control the stock markets through our actions than we can control the roll of dice or lottery drawings. As investors, it is important that we are aware of and overcome these psychological challenges. For many, this means putting their investment decisions in the hands of professionals who can remove the emotions and biases from their decisions.

"The closest to being in control we will ever be is in that moment that we realize we're not."

Brian Kessler

Stock Market Pulse

Index	5/31/13	% Change Since 12/31/2012
S&P 1500	377.72	15.52%
DJIA	15,115.57	16.56%
NASDAQ	3,455.91	15.07%
S&P 500	1,630.74	15.37%
S&P 400	1,184.32	16.74%
S&P 600	551.98	16.36%
NYSE Composite	9,302.27	10.17%
Dow Jones Utilities	482.16	8.22%
Barclays Aggregate Bond	109.11	-0.99%

P/E Multiples	5/31/13
S&P 1500	15.8x
DJIA	14.7x
NASDAQ	16.5x
S&P 500	15.5x
S&P 400	18.5x
S&P 600	19.4x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.03%
T Bond 30 Yr	3.30%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	377.72	15.8x	2.05%
S&P 500	1630.74	15.5x	2.14%
DJIA	15115.57	14.7x	2.34%
Dow Jones Utilities	482.16	NA	4.02%

Spread Between 30 Year Government Yields and Market Dividend Yields: 1.25%

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