GREENLEAF® TRUST

Perspectives

A Greenleaf Trust Newsletter

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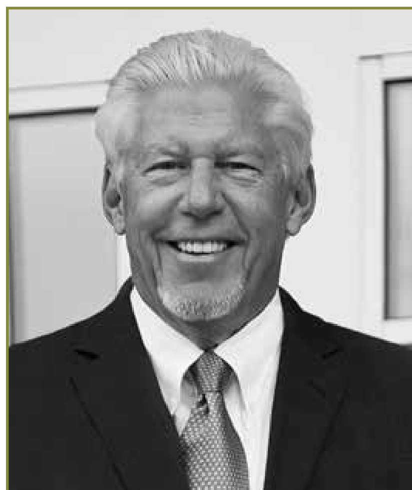

William D. Johnston
Chairman, Greenleaf Trust

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Economic Commentary

For the past twenty-four months and twenty-four newsletter articles, I have led with COVID-19 related data. The reasoning was that our economic recovery would depend upon our progress at defeating the pandemic created by the COVID-19 virus. This month, while the impact of the virus remains with us, Russia's invasion of Ukraine has replaced the pandemic on the front page. The economic and geopolitical consequences of the invasion are real and worthy of our attention. History is complicated, and Eastern European history is very complicated. Modern diplomacy and detente is often obliterated by over seven hundred years of conflict, power struggles, invasions, revolutions, geographical realignments, imperialistic intents, famines and outright declared wars. In most cases within Eastern Europe, the resulting wars produced peace treaties and agreements which were unpopular and resented by those who suffered the horrors of the warfare.

A victor's redrafting of a country's geographical boundaries didn't make those boundaries real to the people living there. It didn't change language, religion, art, music, traditions or cultural identity. For over two hundred years, between 1772 and 1991, the country we now know as Ukraine was occupied and controlled by the Russian Empire and Habsburg Monarchy, which then became a part of the Soviet Union after the revolution of 1917. The collapse of the Soviet Union in 1991 returned independence to Ukraine for twenty-three years until the 2014 Crimea (think eastern and southeastern Ukraine) invasion by Russia, supposedly to rescue Russian-backed dissidents who were trying to overthrow the elected majority governing Ukraine. The civil-war-like history between Crimea and Ukraine includes families divided by political, not religious, preferences — with both Ukraine and Russia fighting to influence the struggle of those caught in the battle for sovereignty.

Enter Vladimir Putin. Dictators consolidate power, squash dissent, control the narrative, control public information, and uniformly abandon human and individual citizen rights by suspending or corrupting democratic elections while they seek to expand geographies they control. Substitute any dictator that you know of throughout history for Vladimir Putin, and you will see identical behaviors. Beyond the fact that Vladimir

Commentary, continued

Putin is a dictator, what is his motivation and expected gain from invading and potentially controlling Ukraine and not just Crimea? Beyond the cynical thoughts of Putin acquiring greater personal wealth through manipulation of natural resources, currency and financial assets, we are left to understand his political vulnerabilities. In the thirty-one years that Ukraine held independence, from 1991 until the invasion this month, they were making significant progress toward becoming a market-based economy and rising on the scale of democratic practices through free elections. Beyond their ascendency to a more democratic and free market economy was their attraction to becoming a member of the European Union and expressed desire to become a member of NATO. This is not a conflict of communism vs. democracy. Putin is not a communist and Russia, where it advantages the political elites and oligarchs, is very much a market-based economy. It very much is, however, a struggle between the European Union legitimacy that Ukraine could gain and the protection it would garner by being a NATO member nation. Putin has expressed many times that he believes the most catastrophic event that ever occurred to Russia was the destruction of the Soviet Union, and the resulting independence of countries on Russia's border that were previously a part of the Soviet Union. Don't mistake that his lament is for communism, but rather geography, wealth and resources to combat the European Union economically and militarily to deter what he believes to be the threat of NATO and, by implication, the west.

"This is not a conflict of communism vs. democracy. Putin is not a communist and Russia… is very much a market-based economy."

Russia has not done well in imperialistic struggles. It is early to compare this invasion to Russia's occupation of Afghanistan; however, it seems a mistake to assume that the Ukrainians are unwilling to fight, and an additional mistake to think that NATO will not deliver arms to Ukraine when needed. Additionally, mid-term elections in the United States are approaching. Republicans seeking to return to power will seek political advantage by criticizing President Biden's efforts to deter Putin's actions. The NATO alliance and unification of the European Union in economic sanctions against Russia seem, on the surface, a tough policy to criticize — though, anymore, there seems to be no policy safe from political posturing even if it is nonsensical. Natural resources are always powerful. Russia needs to sell them and Europe needs to buy them. Every negotiation has its own sense of urgency. Controlling the narrative in the social media world we live in is more difficult for dictators than ever before. Body counts of Russian soldiers will be broadcast, photos of destroyed Russian helicopters, fighter jets and tanks will be blasted and tweeted around the clock. The six hundred billion dollar cash reserve that Russia accumulated by selling assets prior to the invasion sounds huge, until it is required to be spent down by sanction-imposed interruptions in commerce. When you

build your economy on being a producer and supplier of energy, you must also understand the implications of interrupting the chain of distribution through self-inflicted policies and actions. War is horrendous and man's inhumanity to man will be on full display in this conflict or, as Putin refers to it, this military exercise. When the sense of urgency intensifies enough, real negotiations will occur and the inhumanity will stop. Let's hope that we get there quicker rather than later.

The global supply chain is still in disrepair. A war of consequence and long duration will delay the repair of the supply chain further, thereby increasing inflation pressure. Around the margins there are things that can be done to increase our country's energy supply, but our supply chain of all products is global in nature; our independent actions specific to our country alone are not likely to ease energy-related prices significantly. The Federal Reserve has made their position on credit tightening clear, though that position was made prior to the Russian invasion of Ukraine. Until we see and hear differently from the Fed, we can expect their stance on interest rate hikes to continue; however, we will also expect them to maintain a watchful eye on their full mandate that includes more than just inflation data.

COVID-19 is still here, but as I mentioned last month, we are apparently done with COVID-19. Infection rates as a percentage of population are declining, hospitalizations are declining and outcomes are improving with some notable exceptions. People who are vaccinated and boosted fare the best with lower infection rates, significantly lower hospitalization rates and nearly no mortality. Those unvaccinated with comorbidities continue to suffer devastating effects of being infected. Bloomberg's global vaccination model now indicates that full immunity globally (75% total vaccination) is still five months away, but for many countries has already occurred. The good news is that the rate of daily global vaccinations has held steady at 28.9 million. The United States will be approaching 70% vaccinated by mid-April.

Restrictions are being lifted, masks are becoming more optional than required and gathering is picking up pace. Opportunities for ranting about restrictions and requirements are diminishing, which will require some to look for other ways to vent their rage. What are the chances it will be replaced by increased civility? Just kidding.

The New York Federal Reserve Weekly Economic Index through February 24 was reported at 6.84%, which is relatively steady from last month, which indicates an annual real GDP growth rate of 5.56%.

"Opportunities for ranting about [COVID-19] restrictions and requirements are diminishing, which will require some to look for other ways to vent their rage."

Michael F. Odar, CFA®
President

Finding Talent

We have all read the headlines about the tight labor market and have seen the help wanted signs around all of our communities (I counted 17 on my 20-minute commute into the office this morning). Without going into the myriad of reasons why we have a tight labor market, suffice to say that it is, in fact, really tough to find talent right now. For a rapidly growing company with a team-based service model like Greenleaf Trust, this can be problematic.

We currently have 18 open positions, and it's not because we have had significant turnover. Our turnover rate is below 5%. It's because our growth requires it.

Our recruiting team is amazing, but they can't do it all. We know that just like most of our clients have come from referrals from existing happy clients; most of our new teammates have also come to us from referrals from current teammates. So, I wanted to get the word out to those who know who we are, what our core values are, and how our culture differentiates us.

"… just like most of our clients have come from referrals from existing happy clients; most of our new teammates have also come to us from referrals from current teammates."

Below is a list of open positions we currently have throughout the state of Michigan. As you know, we are a talent-based organization. We can teach candidates specific job-related skills, but talents like being empathetic, ethical, results driven, resilient, innovative, and a good team player are innate.

Business Development Officer
Retirement Plan Division
Grand Rapids, MI

Database Application Support Specialist
Kalamazoo, MI

Estate Settlement Coordinator
Kalamazoo, MI

Family Office Coordinator
Grand Rapids, MI

Financial Planning & Analysis Lead
Kalamazoo, MI

Institutional Wealth
Management Advisor
Kalamazoo, MI

Managing Director
Birmingham, MI

Project Manager
Kalamazoo, MI

Talent Acquisition Specialist
Kalamazoo, MI

Tax Coordinator
Kalamazoo, MI

Team Service Coordinator
Birmingham, MI

Team Service Coordinator
Grand Rapids, MI

Team Service Coordinator
Midland, MI

Trust Operations Specialist
Kalamazoo, MI

Trust Relationship Officer
Birmingham, MI

Trust Relationship Officer
Grand Rapids, MI

Trust Relationship Officer
Kalamazoo, MI

Wealth Management Advisor
Kalamazoo, MI

If you know of someone who would thrive in our culture in one of these roles, have them go to our website (www.greenleaftrust.com) or contact us at GTHR@greenleaftrust.com. We would love to speak with them.

Global Equity: Revisiting Diversification in Risky Times

Lucas W. Mansberger, CFA®, CAIA®
Vice President, Investment Strategist, Senior Manager Selection Analyst

Greenleaf Trust has long been an advocate of diversifying equity portfolios across the stocks of both US and non-US companies. However, over the past several years, the returns of domestic equities have consistently outpaced non-US equities. This has led some to question whether investing in non-US equities is still prudent. Additionally, recent high profile geopolitical events, most notably the current Russian incursion into Ukraine, have led to a focus on the potential risks of investing outside of the US.

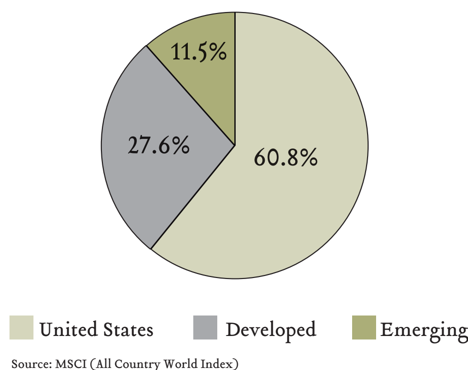
In light of these concerns, in this article we will briefly revisit the key arguments for diversifying a stock portfolio into non-US companies. We will then take a look at current Russian and broader non-US exposure within Greenleaf client portfolios to understand better what global equity diversification looks like in "real time."

"... we will briefly revisit the key arguments for diversifying a stock portfolio into non-US companies."

WHY DIVERSIFY INTO NON-US STOCKS?

1. Gain Exposure to a Broader Set of Leading Companies
   Nearly 40% of the world's equity market capitalization is outside of the US, including many of the world's largest and most successful companies. Expanding the opportunity set to non-US markets also results in a significantly larger number of companies available for investment. As an example, within the MSCI All Country World Investable Market Index, there are approximately 2,600 broadly investable publicly-traded companies listed in the US and approximately 6,700 listed in non-US markets.

Global Market Cap
(January 2022)

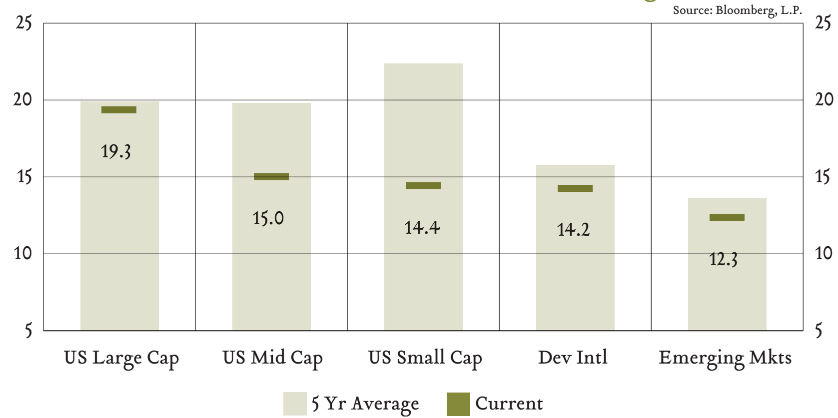


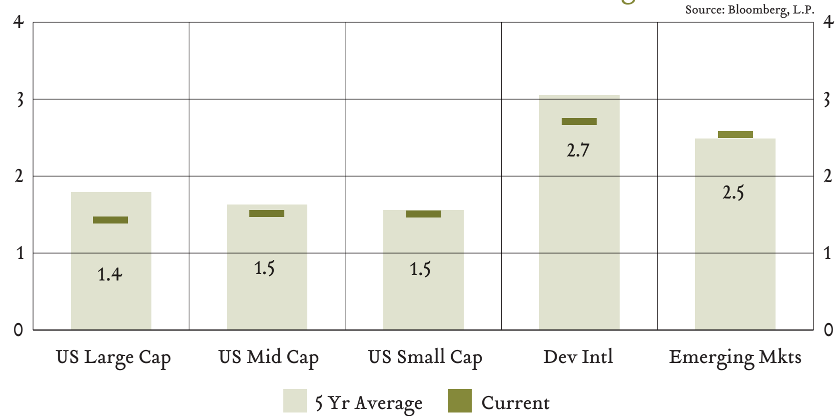
Source: MSCI (All Country World Index)

2. Access Diversified Return Drivers
   US stocks have experienced stronger earnings growth that non-US

Global Equity: Revisiting Diversification in Risky Times, continued

stocks in recent years, which has been a key driver of returns. However, from a valuation perspective, non-US stocks currently appear cheaper than US large-cap stocks, both on an absolute basis and relative to their respective recent histories. Non-US stocks also offer a meaningful yield advantage.





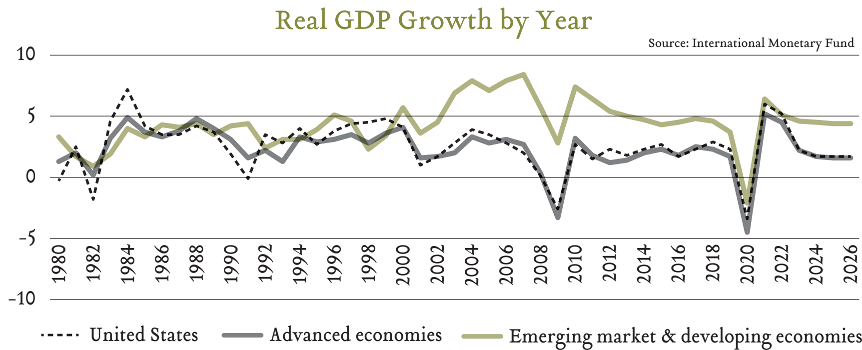
> "… currencies should have no additive or negative affect to returns over the long term, over shorter time frames they can offer favorable diversification benefits."

Additionally, non-US stocks offer exposure to a number of foreign currencies. While we believe that currencies should have no additive or negative affect to returns over the long term, over shorter time frames they can offer favorable diversification benefits.

When all is said and done, the inclusion of non-US equities into a US equity portfolio has consistently resulted in a reduction of overall volatility and downside risk over longer timeframes.

3. Exposure to Other, Faster Growing Economies

Today, the US gross domestic product (GDP) comprises only 25% of global GDP, down from 35% in 1985. Meanwhile, emerging and developing economies now account for 40% of global GDP, nearly twice what they contributed in 1985, and are expected to continue to grow faster than developed economies in the coming years.



RUSSIA: TESTING GLOBAL EQUITY DIVERSIFICATION IN REAL TIME

The incursion by Russia into Ukraine is a significant event with substantial ramifications for markets the world over. It has generated significant stock market volatility. Russia's stock market itself has fallen 48.6% month to date and 53.1% year to date through the date of this writing (2/24).

However, while the onset of war in Europe has global market implications, in aggregate our clients have minimal exposure to Russia. A balanced portfolio comprised of 60% global equities and 40% bonds aligned with our recommendations has approximately 0.3% exposure to Russian markets.

It is important to note that our typical global equity allocation is diversified across many non-US markets. Markets around the globe have not responded in a uniform fashion to the Russian incursion and reflect other dynamics affecting the global economy, such as the rise in commodity and energy prices.

In developed markets, while European countries (-11.1%) have underperformed the S&P 500 (-9.8%) year to date, developed Asian countries have outperformed (-6.7%) by over 300 basis points. In fact, in emerging markets, there are actually more countries that have experienced a positive return year to date (13) than have had a negative return (12), with Latin American (+9.5%) and Gulf Coast (+8.8%) countries seeing particularly strong outcomes. In the aggregate, both developed markets (-9.6%) and emerging markets (-6.2%) have outperformed the S&P 500 year to date, demonstrating the benefits of global diversification despite the headline risk.

"...while the onset of war in Europe has global market implications, in aggregate our clients have minimal exposure to Russia."

CONCLUSION

When unexpected economic events or geopolitical maneuvering lead to an increase in the risk of certain assets or regions, it can be easy to forget the fundamental principles and insights informing the structure of one's investment portfolio. Upon reexamination, we believe that the reasoning behind a globally-diversified approach to equity investing remains sound, and that global diversification can provide benefits even in the thick of high short-term volatility.

Daniel L. Baker, J.D., CTFA
Senior Vice President,
Director of Business Development,
Trust Relationship Officer

The Value of Valuation Discounts in Transferring Ownership of Family Owned Businesses

Valuation discounts, often utilized in connection with the transfer of ownership interests in family-owned or closely-held businesses, are a valuable estate planning tool. These discounts have gotten a good deal of press lately.

Last September, the Build Back Better Act (BBBA) (H.R. 5376) was introduced in the House of Representatives. In its original form, the proposed legislation included a provision which would have effectively eliminated valuation discounts on the transfer of entities that hold "nonbusiness" or "passive" assets, including cash, stocks, bonds and real estate not used in an "active trade or business." This was not the first legislative assault on valuation discounts. In fact, there have been repeated efforts to eliminate this tool either legislatively or through regulatory processes since the 1970s. As with other attempts, the 2021 effort to severely limit the use of such discounts failed—being left on the cutting room floor prior to the final bill ultimately being passed by the House. As you likely know, the BBBA, sans the discounting rule modifications, never made it to a vote in the Senate — largely due to the widely-reported opposition to the bill by Democratic Senators Joe Manchin and Kyrsten Sinema.

> "Valuation discounts… have gotten a good deal of press lately."

It would be reasonable to believe, while valuation discounts are still available to business owners and their estate planning attorneys and financial advisors, that such discounts have not stared down the executioner for the last time. In its never-ending quest for additional tax revenues, it is likely that a future Congress will once again look to modify or eliminate the current valuation discount laws and regulations. In addition, it is very likely that the unified credit, which in 2022 allows an individual to gift during his or her lifetime or upon death a total of $12.06 million without paying gift or estate taxes ($24.12 million for a married couple), will be reduced significantly in the next few years. Under current law, the credit is scheduled to revert to its pre-2018 level of $5 million, as adjusted for inflation, at the end of 2025, but many expect it to be reduced in a future spending bill prior to that. When the unified credit is reduced, those who have not used the "extra" exemption will lose it forever. Taken together, the possibility (some might say probability) of changes to both valuation discounts and the unified credit in the next few years makes it especially important for owners of sizable businesses to consider revisions to their estate plans and the utilization of valuation discounts to transfer ownership to the next generation.

The goal of applying discounts with family or closely-held businesses is

typically to reduce valuations for estate tax purposes while allowing gifts of an ownership percentage to children or grandchildren at a reduced rate. Oftentimes these ownership interests are placed and held in limited liability companies or family limited partnerships.

The standard valuation of a business interest for gift and estate tax purposes is "fair market value"—generally defined as the hypothetical price arrived at for a business between a willing buyer and a willing seller, neither being under any compulsion to sell and both having reasonable knowledge of relevant facts.

To receive a valuation discount, a business owner would typically split up the ownership interests in the business and gift or sell such partial interests to children or irrevocable trusts established for the benefit of those children.

The most common valuation discounts used in transferring ownership interests in family owned businesses are those for lack of marketability, lack of control and minority interest or share. These discounts, alone or in combination, may range from 10% to 50% or higher depending on a number of factors. The discounts are not routinely stacked on top of one another, meaning that successive discounts are applied to an already discounted number, e.g. if an ownership interest is valued at $10 million and the first discount is 20%, a second discount of 20% would be applied against an $8 million valuation, the original valuation already having been reduced by $2 million.

LACK OF MARKETABILITY. This discount is often called a liquidity discount and reflects the fact that unlike publicly traded companies, interests in closely-held businesses have no ready market. The discount is the difference between the value of a stock that is publicly traded (and has a market) and privately held stock which has little or no market. Various methods may be employed in determining an appropriate lack of marketability discount and discounts in the 25% range are not out of the ordinary where a compelling case is made.

LACK OF CONTROL. This discount is applied when the ownership interest is noncontrolling or consists of non-voting shares and reflects the fact that owners of such interests are unable to make business decisions such as, determining compensation, declaring dividends and deciding to sell or liquidate. The discount reflects the difference in value between an ownership interest with those qualities and one without. Depending on the facts and circumstances, and what other discounts are claimed, the discount for lack of control may also be as much as 25% or more.

MINORITY INTEREST. This discount reflects that a partial ownership interest may be less than its proportional share, i.e. a 49% interest may be worth less than 49% of the company's overall value because the minority interest has no ability to control management or other critical aspects of the business. Discounts for minority interest are often in the 25% range, again depending on the unique circumstances of the company and

"To receive a valuation discount, a business owner would typically split up the ownership interests in the business and gift or sell such partial interests..."

The Value of Valuation Discounts in Transferring Ownership of Family Owned Businesses, continued

ownership interest.

Here is an example of how these discounts might be applied together to substantially reduce the amount of the lifetime estate exemption used (thus preserving the "discounted" amount for additional and future gifting):

> Bob owns 49% of a family limited partnership ("FLP"). He is not the manager. The FLP owns a large commercial farm valued at $8 million. It also owns $10 million in liquid investments and another $20 million of private equity interests spread across a number of medical device companies. All in, the FLP is valued at $38 million with Bob's fully valued 49% interest equaling $18,620,000. Bob has chosen to gift his shares to his children. He may avail himself to at least three discounts.
>
> - Bob may receive a discount for lack of marketability since as a minority shareholder he would likely have difficulty selling his share since he has no control over the underlying investments. For illustration purposes, let's say that discount is 25%
> - As a non-managing owner, Bob may also be entitled to a lack of control discount which may be another 20%.

As a minority shareholder, Bob may be entitled yet another discount. This final discount might further reduce the already discounted value by 10%.

"… valuation discounts can have a tremendous impact on preserving family wealth and facilitating the transfer of family owned businesses from one generation to the next."

If Bob gifted his 49% interest in the FLP in 2022, without using valuation discounts, the value of the gift would be equal to his 49% interest, or $18,620,000. This would result in a gift tax owing (by Bob) of $2,624,000 ($18.62M minus his $12.06M lifetime exemption amount multiplied by 40% (the gift tax owing on gifts made in excess of the 2022 exemption amount)). Furthermore, Bob would have to use his entire gift and estate tax exemption and all future gifts during Bob's lifetime or upon his death would be subject to a 40% tax.

In our example above, by utilizing the three valuation discounts, Bob is able to gift his entire interest in the FLP (at a 46% cumulative discount) to his children estate and gift tax free, and use only $10,054,800 of his lifetime exemption. If he had not previously used any of his exemption and made the gifts in 2022, he would still be able to gift another $2,005,200 estate and gift tax free at some point in the future.

As you can see, valuation discounts can have a tremendous impact on preserving family wealth and facilitating the transfer of family owned businesses from one generation to the next. If you are a business owner who would like to see it remain in the family and expect to have a taxable estate, now would be a good time to review some ownership transfer and valuation discount options with your financial advisor and estate planning attorney.

Over the Rainbow

Nicole E. Asher, CFP®, CPWA®, ChFC®
Vice President
Senior Wealth Management Advisor

Planning for retirement is not only important from a financial perspective, but from a psychological perspective as well. Being prepared financially for retirement is critical, but the emotional impact is one that is often overlooked. Moving from a busy career into uncharted territory creates excitement as well as anxiety.

The path to retirement reminds me a little of Dorothy's walk down the Yellow Brick Road from the classic movie, *The Wizard of Oz*. Like the Lion, Scarecrow and Tin Man that she encounters along the way, as our clients transition to and enjoy retirement; they need the same things that the Scarecrow, Tin Man and Lion are hoping that the Wizard can grant them brains, heart and courage.

"If I only had a brain…" Don't worry, retirement does not require you to get a masters or a doctorate, but it does require you to make smart choices. One of these choices is to hire a holistic wealth manager prior to retirement to assist you in determining whether or not you can afford to retire and what retirement will look like. This facet of retirement is the one that gets the most attention, and rightfully so. It includes the financial building blocks that can ease the transition and help you fulfill your retirement dreams.

The non-financial aspects of retirement require both heart and courage. When a person retires, their status quo changes and sometimes dissolves. People often lose their sense of self without even knowing it. The career that they worked so hard at for so many years is now in the past and is no longer the focus of their lives. It often takes time to find a new "normal." Retirees often find it difficult to find anything sufficiently meaningful to replace their full fledged career. It surprised me to learn that people find it harder to figure out what to do with financial independence than to achieve it in the first place.

"The non-financial aspects of retirement require both heart and courage."

The dictionary defines retirement as "a state of being withdrawn from the rest of the world or from a former busy life"; "the act of withdrawal from one's occupation or business into privacy, seclusion or retreat." Synonyms for retirement include: confinement, detachment, disintegration, emptiness, escape, exodus, free time, goof-off time, idle hours, isolation, journey, leisure, loneliness, loss, pause, quarantine, quiet, silence, spare time, unemployment, vacation, vanishing, wasteland and wearing away. If you're reading this and thinking that retirement doesn't sound like much fun, remember what I said before, retirement takes courage and heart. It doesn't mean that you do nothing; it means you now have the opportunity to do anything! With that in mind, you need to plan what your activities in retirement will be so that

Over the Rainbow, continued

your retirement doesn't look like a synonym from a thesaurus!

People want to be productive at any age. So, whatever the reason you're considering retirement or have retired, voluntarily or involuntarily, achieved retirement age, or let go when your company is acquired, you have an opportunity you may never again be offered. You're invited to identify what you want to do and you need to find the heart and courage to do it!

Here are a few questions you may want to consider:

- How can I discover what I really like to do?
- Would I enjoy volunteering?
- Are networking clubs worthwhile?
- What will my second or third act look like?
- Should I start my own business?

"So, whatever the reason you're considering retirement or have retired… you have an opportunity you may never again be offered."

Try taking a multi-layer approach and look for activities that encompass the following:

Intellect – Think!

Look for things that require you to stretch your mental capacity. Taking or teaching a class on a topic that interests you, but you were too busy to do when you were working. Cards, games and puzzles can also be intellectually stimulating.

Physical - Get moving!

Try something that will improve your strength, aerobic capacity, balance and/or flexibility. Most communities and gyms offer a wide range of classes including ballroom dancing, yoga or even Pilates. Many of these classes do not require you to be physically fit to participate, and some are even designed for older adults. Water aerobics is wonderful for all fitness levels and beneficial for those who suffer from arthritis and would otherwise not be able to exercise.

Social – Make friends!

Reach out to old friends that you were too busy to see when you were working, and look at forming new relationships with other retirees.

Creative – Use your imagination!

Put your life story down in words to pass on to future generations. Start a journal of your travels, try new recipes, create a garden, or teach yourself how to draw or paint.

Spiritual – Reach out!

Whether you find spirituality for yourself or contribute to the welfare of others, retirees often report this as deeply beneficial. Donate your time and skills to organizations that are in desperate need of volunteers from every walk of life.

The key to a successful and fulfilling retirement is finding the right blend of relaxation, freedom and purpose to keep you engaged and eager to get out of bed every morning. Retirement won't always be ruby slippers and trips to the Emerald City. If you don't plan accordingly you may encounter a few Flying Monkeys or even a Wicked Witch or two. So, as you prepare for retirement or as you enjoy your current retirement; have a plan, focus on the positive and always know that somewhere over the rainbow, skies are blue, and the dreams that you dare to dream, really do come true.

"The key to a successful and fulfilling retirement is finding the right blend of relaxation, freedom and purpose..."

Required Annual Testing in Qualified Retirement Plans and Solutions to Consider

Kathleen J. Waldron, QKA®
Vice President, Assistant Director of Retirement Plan Division

At this time of year retirement plan providers are busy completing the annual Actual Deferral Percentage (ADP) tests for qualified retirement plans which contain a salary deferral or Roth 401(k) component. This test in particular can be very impactful to certain plan participants. This is a non-discrimination test for 401(k) plans mandated by the Internal Revenue Service (IRS) to ensure that a plan does not unduly benefit highly compensated employees (HCE) at the expense of other employees. It is one of many tests in the suite of compliance testing that Greenleaf Trust prepares on behalf of our retirement plan clients. Under the ADP testing rules, the average employee contributions (both pre-tax salary deferrals and Roth 401(k) contributions) of the highly compensated employees and non-highly compensated employees (NHCE) are calculated and compared on an annual basis based on the plan year. To pass the test, the ADP of the HCE group may not exceed the ADP for the NHCE group by 1.25 percent or 2 percentage points. If the plan fails the ADP test, corrective action must be taken to protect the qualified status of the plan arrangement. The law and related regulations provide various methods for correcting failures during a "correction period." This statutory correction

period is the 12-month period following the close of the plan year in which the failure occurs. If corrective distributions are made after the first 2 ½ months of the correction period, the employer (not the HCE) is liable for excise tax. If correction is not made within the correction period, the plan is considered disqualified. In essence, however, it is important to note that there is no inherent problem with failing the test as long as corrective action is taken within the proper time frames.

Failing this test can inhibit employee contributions to a 401(k) plan by individuals who meet the criteria and are considered highly compensated. Receiving a distribution of previously deferred compensation dollars including any gains or losses is often not well received by most individuals who may be impacted following an ADP test failure.

One solution to this problem is to incorporate a safe harbor provision to the plan. This option, while adding costs, would alleviate the requirement for completing the annual ADP test, thus allowing all HCE's to defer the maximum amount allowed by law and no returns of contributions would be required. There are two basic options for a safe harbor contribution provision.

1. 3% Safe Harbor Non-Elective Contribution
2. Basic or Enhanced Safe Harbor Matching Contribution

The first option is a 3% mandatory employer contribution to all eligible participants based on compensation. Some things to consider regarding this option include:

a) All participants who have met the plan's definition of eligibility share in this contribution regardless of whether they terminate within the plan year or work less than 1,000 hours.
b) The Safe Harbor Non-Elective Contribution source is immediately vested in the participant's account (cannot attach a vesting schedule).
c) Generally, the 3% Safe Harbor Non-Elective Contribution may satisfy a top heavy mandatory contribution requirement.
d) This contribution can be easier to budget as it is a straight percentage of compensation.

The second option is a mandatory employer matching contribution which is composed of different tiers based on the basic or enhanced design. A few things to consider with this option are:

a) The Safe Harbor Matching Contribution is only made for those participants who are contributing pre-tax salary deferrals or Roth 401(k) dollars into the plan.
b) Participants who contribute would share in the Safe Harbor Matching Contribution regardless of whether they terminate within the plan year or work fewer than 1,000 hours.

"the annual ADP test… is a non-discrimination test… to ensure that a plan does not unduly benefit highly compensated employees…"

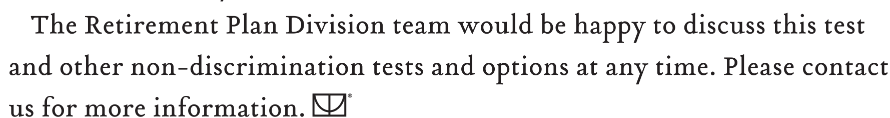
c) The Safe Harbor Matching source is also immediately vested in the participant's account (cannot attach a vesting schedule).
d) This contribution may not satisfy any top heavy mandatory contribution.
e) This contribution is more difficult to budget as costs could potentially be high if everyone participates in the plan to the fullest extent.

The basic safe harbor employer match formula is 100% of salary deferrals up to 3% of compensation deferred plus 50% of salary deferrals up to the next 2% of compensation deferred.

The safe harbor employer matching contribution option requires an annual notice which must be provided to all employees no later than 30 days prior to the beginning of the plan year. Ongoing, on an annual basis, a plan sponsor must declare that the plan will be a safe harbor design.

Another solution to the problem of failing this annual test is to add an automatic enrollment feature to the plan. With proper plan documentation and notification to plan participants, this feature allows a plan sponsor to automatically deduct an allowable percentage from a participant's compensation into the plan. Automatic escalation provisions are also permitted which allows an annual increase of such deferrals of generally one percent. This option is beneficial in multiple ways. It helps with the inertia or inaction of employees to start saving in the qualified retirement plan. Additionally, by automatically enrolling plan participants into the plan, the deferral rate for those not previously participating will increase and, over time, likely lessen the effects of the ADP test failure or remove the failure entirely.

The Retirement Plan Division team would be happy to discuss this test and other non-discrimination tests and options at any time. Please contact us for more information.



"Another solution to the problem of failing this annual test is to add an automatic enrollment feature to the plan."

Stock Market Pulse

Index	2/28/22	Total Return Since 12/31/2021
S&P 1500	998.75	-7.86%
Dow Jones Industrials	33,892.60	-6.43%
NASDAQ	13,751.40	-12.00%
S&P 500	4,373.94	-8.02%
S&P 400	2,661.48	-6.18%
S&P 600	1,316.11	-5.97%
NYSE Composite	16,313.89	-4.67%
Dow Jones Utilities	942.54	-3.34%
Barclays Aggregate Bond	2,278.69	-3.25%

P/E Multiples	2/28/22
S&P 1500	22.0x
Dow Jones Industrials	18.0x
NASDAQ	103.8x
S&P 500	22.4x
S&P 400	17.9x
S&P 600	18.0x

Key Rates

Rate	Value
Fed Funds Rate	0.00% to 0.25%
Tbill 90 Days	0.32%
T Bond 30 Yr	2.16%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	998.75	22.0x	1.41%
S&P 500	4,373.94	22.4x	1.40%
Dow Jones Industrials	33,892.60	18.0x	1.88%
Dow Jones Utilities	942.54	18.2x	3.40%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.75%

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