GREENLEAF TRUST

Perspectives

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Economic Commentary

We are now 49 months into our recovery from one of the most devastating financial implosions in our globe's history. This afternoon we will hold our regularly scheduled conference call for our clients and, as we do each quarter, we will provide a current update on the economy as well as the equity and fixed income markets. We are now well into what some call the "silly season" of politics. Depending upon what side of the political aisle you get up on, you either think that the economy is the worst that you have seen and is getting even weaker, or you admit to the slow growth reality but are optimistic about the forward period of time. We will try to present facts through data, even if it doesn't satisfy either of the above perspectives. Before we get to the most recent data points of the economic indicators we have been monitoring, let's remind ourselves of what our thoughts were back in January of 2009.

At the onset of recovery we offered the following forecast:

1. Recovery would be prolonged and last from 2009 well into and perhaps through 2014.
2. GDP growth would be modest by other recovery standards and range from the low 2% range to a high of 3.5%.
3. Modest growth would be a significant challenge to change unemployment rates and that more robust growth would not occur until 2014.
4. Home values would deflate to 1998/1999 levels before the housing market would stabilize further dampening the recovery.
5. All of the above would require tremendous political will and make our recovery vulnerable to geopolitical as well as domestic political difficulties.
6. Lastly, our recovery would be in steady incremental steps over long duration and data would not inspire confidence in a rapidly deleveraging consumer.

The above forecast is relevant to review, not because I have any desire to say "I told you so," but rather to provide a barometer to gauge where we have been, where we are now and where we are headed. The current data in the chart that follows shows us incremental progress, cumulative recovery and significant issues still in the way of stronger growth. First the data, then the analysis.

Commentary, continued

"The current period data suggests continued incremental improvement in most areas, some troubling reversals in other important indicators and contradictions in others."

DATA POINTS	Q1 2010	JUNE 2010	SEPTEMBER 2010	APRIL 2011	JULY 2011	JULY 2012	SEPTEMBER 2012
Labor Force	153.2 million	154.4 million	154.1 million	153.4 million	153.4 million	153.5 million	154.6 million
Employed	138.9 million	139.4 million	139.2 million	139.8 million	139.3 million	139.6 million	142.01 million
Initial Jobless Claims	452,000	457,000	453,000	388,000	422,000	408,000	359,006
Unemployment Rate Percentage	9.7%	9.7%	9.6%	8.8%	9.2%	9.2%	8.1%
Average Unemployment Duration	31 weeks	34.4 weeks	33.6 weeks	39 weeks	39.9 weeks	40.3 weeks	39.2 weeks
Consumer Confidence	52.3%	63.3%	48.5%	63.4%	58.5%	60.1%	70.3%
Purchasing Managers Index	60.4%	59.7%	54.4%	61.2%	55.3%	51.6%	49.6%
Non-Durable Goods Orders	$206 billion	$226.0 billion	$216.7 billion	$245 billion	$248.9 billion	$251.0 billion	$248.0 billion
Durable Goods	$179 billion	$192.0 billion	$191.2 billion	$200 billion	$195.6 billion	$201.0 billion	$198.0 billion
Domestic Autos Sold	165,656	189,000	146,000	195,288	198,000	199,000	199,899
Consumer Spending	$10.3 billion	$10.4 billion	$10.37 billion	$10.7 billion	$10.7 billion	$10.8 billion	$11.2 billion
New Home Sales	308,000	300,000	288,000	301,000	319,000	460,000	373,000
New Housing Permits	650,000	574,000	569,000	517,000	612,000	620,000	803,000
New Housing Starts	605,000	593,000	598,000	479,000	560,000	571,000	294,000
Credit Markets							
Muni Bond Buyer Index Yield	5.2%	5.17%	4.87%	5.7%	5.25%	4.23%	4.19%
Dow Jones Corp. Bond Index	4.30%	4.14%	3.45%	3.93%	3.70%	2.79%	2.72%
Yield Gap On DJIA To Bond Index	-3.1%	-2.84%	-2.31%	-2.85%	-2.65%	-1.25%	-1.17%
Ten Year Treasury	3.85%	2.97%	2.54%	3.47%	2.99%	2.00%	1.56%

The current period data suggests continued incremental improvement in most areas, some troubling reversals in other important indicators and contradictions in others. As you can see, we have about the same workforce numbers as we did heading into the teeth of the recession yet appear to have approximately four million more employed than we did at the bottom of the recession. Four million jobs is a lot to add over this time period so why hasn't it translated into more growth? The answer is of course that from the beginning of the recession to the bottom, we lost approximately three million jobs so the

total workforce gain over the four year time period is closer to one million or equivalent to the workforce population gain over the same time. You might characterize it as standing still which is why confidence has lagged and U6 unemployment (out of work, not seeking employment and underemployed) is still stubbornly high at 14% and in many urban areas reported as high as 23%. Still, we have added jobs and more people are working. Other good news can be found in lower duration of unemployment, now 39 weeks, longer hours worked, and slightly higher wage though both of the latter are only marginally improved.

For the third month in a row, the Case-Shiller housing data demonstrates the probability that housing has bottomed. Pricing data, days on market, average rental, equivalent rent to own all suggest pricing stability over an entire quarter. Foreclosures continue to decline, though this may not be entirely market driven due to additional help through government backed mortgage programs as well as some commercially available mortgage restructuring. Of the 17 major markets defined in the metropolitan subset of data, 12 showed price increases month over month. This was the largest number of reported increases since late 2007. (Remember from a pricing standpoint the housing market topped in early spring of 2007.)

The disconnect in data is currently centered around indicators of consumer confidence. The most recent release registered 70.3%, which is substantially higher than previous reporting periods, and marks the first time it has topped 70% in many months. We have also witnessed a strong recovery in automobile purchases across a broad demographic set. This is about where the good news begins to dissipate. Consumer confidence, as we know, drives GDP. Several months of 70% confidence levels should move the needle north in GDP growth. It is still too soon to label this indicator release a trend, and the adjacent indicators of production deflate our expectations for such a trend developing soon.

"The disconnect in data is currently centered around indicators of consumer confidence."

Purchasing managers through the traditional PMI index don't mirror consumer's confidence, coming in at a meager 49.6%, which continues a slow but unfortunately steady decline. Durable goods, non-durable and August auto data all declined for the second month in a row though the auto data was not unexpected and was in line with seasonally adjusted expectations. Aircraft orders declined significantly and were being compared with a very robust prior month, however, even when we exclude the aircraft data, (durable goods minus aircraft orders), we still observe disappointing results.

As we look for transparency in earnings reports, we are beginning to see an increase in pre-announcements for earnings adjustments to the downside and most are related to less than expected top line growth with the disappointing drivers being exports to European and Japanese markets. We are in fact seeing

Commentary, continued

the slowdown in revenue growth catching up with lower productivity which had been previously driving earnings. This is probably highly correlated to the PMI index as well as durable goods orders and will not be easily solved in the near term as Europe and Japan are both experiencing a continued fall in demand. All in all, about where we expected to be, but with a slightly more negative color to the analysis.

As I write this, we are 34 days until our Presidential election date. My next opportunity to put this column together will come about the time when we know the result of the election. This contest has been billed by both parties as a clear choice on public policy. Most Presidents, especially those governing in the era of redistricting that reduces the probability of massive changes in congressional body make up, find that their ability to shape public policy is less driven by political capital won through election mandate, than it is driven by traditional coalition building of the entire body politic. The probability of massive change in that body is slim. The fiscal cliff will be before us and those elected will be given the legitimacy as well as responsibility to avoid it. Here's hoping they do.

Getting Mixed Signals— The Message to Stop Saving

Chris A. Middleton, CTFA
Vice President
Asst. Director, Retirement Plan Division

As I write this, interest rates in many countries are at historic lows. Many things have affected the US interest rates, but the two most obvious are capital flight from troubled European economies and Federal Reserve policy.

The Federal Reserve is purportedly manipulating US monetary policy under the banner of creating price stability and maximizing employment. These conscious actions by policy makers of pushing real interest rates (the interest rate net of inflation) into negative territory suggests that our economy needs people to be spending rather than saving. Unfortunately this creates an environment where savers lose money and, therefore, are incentivized to spend instead of save.

This spend happy policy approach may help certain current economic conditions but can become problematic for those relying on saving and "safe" investment returns for retirement. It would be an extreme understatement to say American workers and retirees have become concerned about these current low interest rates causing them to outlive their money in retirement. Interest rates on short-

term bonds and CD's are paltry. Even worse, money markets, and saving accounts are fetching approximately .01%—really, why don't they just say 0%—laughable (as the preferred alternative to crying).

Within the retirement plan business we work diligently to encourage employees to continually raise the percentage of income they save. After all, saving levels are the most important determinant of retirement readiness and success. In fact, the entire concept of the 401(k) plan rests on the assumption that employees will actually contribute meaningful amounts (far more than the current national average) into their accounts. As if that task isn't hard enough, that same employee is saddled with the reality that the safer investment options in the fixed income markets are almost sure to give them no meaningful return for the foreseeable future, not too mention the potential for negative returns that can be witnessed in bond funds as interest rates eventually rise.

So what is with the message that savers are bad for the economy? It has been well documented that approximately 70% of our economic health relates to consumer spending. Although that might well be true, in order to provide the best long-term stability for our economy, consumers need to both spend and save. There is nothing inherently wrong with providing a pro-spending environment, but it sure would be nice too if we did not need to punish great savers along the way by guaranteeing them almost no return on short term investments.

Regardless of policy, we all need to take saving seriously. Preparing for retirement is a personal responsibility and should be planned for regardless of the interest rate environment. How to invest the money being saved becomes more complicated in the current interest rate environment, but that is a topic for a different article.

"Within the retirement plan business we work diligently to encourage employees to continually raise the percentage of income they save."

Dave P. Mange, CFA
Vice President
Senior Research Analyst

"… there is a conceptual puzzle in trying to determine why both US and global bond yields are so low and what investors should do about it."

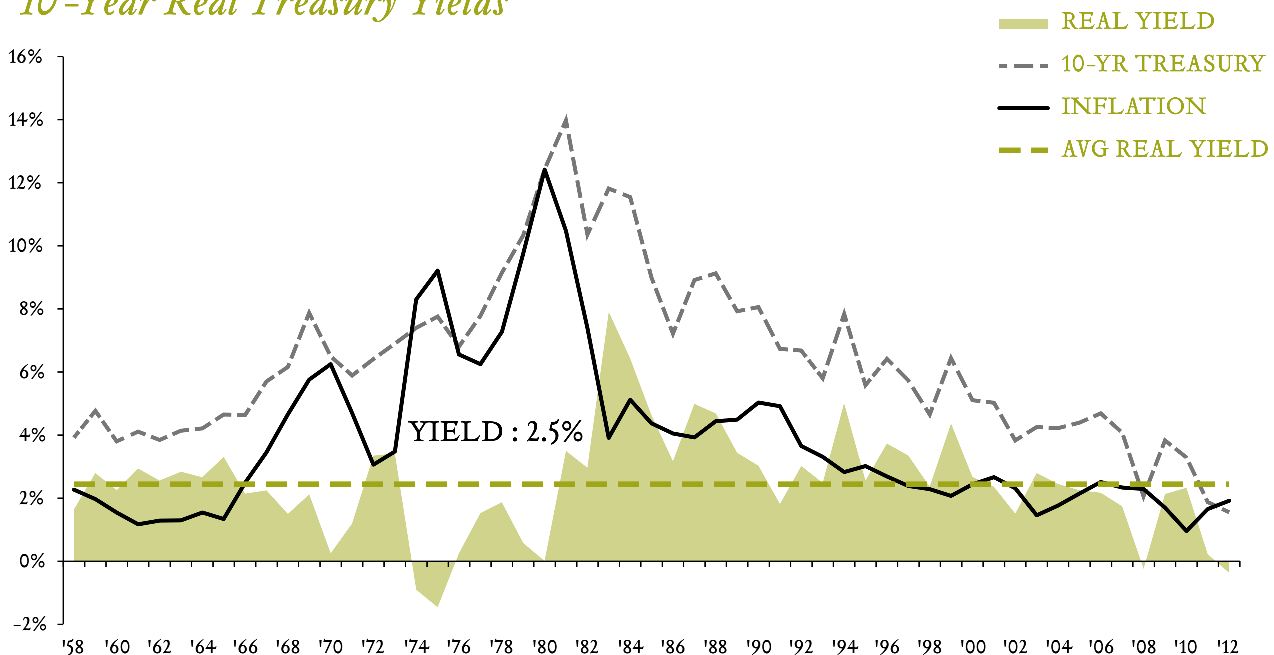
Something Has To Change

I am blessed to be charged with teaching a college level finance course this fall and I am learning a few things while I "teach." Occasionally some of my students seem apologetic when they use simple quantitative models to determine probable value of a stock. My response (which I suppose may not be very helpful) is that simple models are fine as long as they are right.

In that vein, there is a conceptual puzzle in trying to determine why both US and global bond yields are so low and what investors should do about it. A complex model would examine the actions of the US Federal Reserve and other central banks around the world to determine the effect of their fiscal stimulus policies and balance sheet expansions. A simpler model might be to ignore causes and concentrate on the historical relationship between nominal interest rates (the absolute level of bond yields) and "real" or inflation adjusted yield. There are problems with each model, but it is necessary to arrive at a working conclusion in the real world business of money management.

Understanding the Federal Reserve, not to mention the European Central Bank and the International Monetary Fund is a graduate level course in itself and I hesitate to over-simplify their actions; though I will now proceed to do so. The Federal Reserve started to attempt to stimulate the economy by buying fixed income assets that might otherwise be trapped on bank balance sheets; i.e. both good and bad mortgage pools. Then the Fed moved on to buying Treasury bonds to lower (or keep low) interest rates in the hope that low interest rates would stimulate both increased business activity and more risk taking by investors. Arguably, these efforts did not have much effect, although one can never prove what might have happened without those efforts. Now the Fed has moved on to what is known as "QE 3" (QE meaning Quantitative Easing) by turning again mostly to buying additional mortgage backed securities. Most analysts believe that this will not have much effect on the economy, although it has helped the value of US stocks, at least in the short run. Of the $2.5 trillion of fixed income securities owned by the Fed, $1.6 trillion are US Treasury bonds. It is sufficient to say that the yield on Treasury bonds is probably lower than it would be without the Fed's ownership.

If we assume that the Fed is NOT 100% of the cause of low interest rates, we may be able to simplify our analysis. And if the Fed IS the primary cause of low interest rates (this NOT Greenleaf Trust's view) and the Fed is simply seeking to force capital away from the bond



markets into riskier investments, the simple concept expressed in the chart above is still valid.

As indicated by the legend in the upper right corner, the "real yield" or the yield after inflation is illustrated as the solid green fill along the bottom of the chart. On average, investors have demanded a real yield of approximately 2.5% on the ten year Treasury bond for the past 56 years.

This makes intuitive sense since we would not expect investors to accept an erosion of their purchasing power over a long period of time. As an example, if the rate of inflation is (or is expected to be) 2%, investors want an average yield on a ten year bond of 4.5%. Making 2.5% annually is normally not very exciting, but Treasury bonds have relatively little risk.

Today, the ten year Treasury bond offers a yield of just 1.65%. You can do the math at least as well as I can, but "inflation" would have to be negative 0.85% annual for an investor to get the historical average real return. Today, investors obviously do not care about the historical average real return – something else is at work in the bond market.

The last time the US Treasury market offered a similar negative real return was from approximately 1974–1976. This was during and immediately after a fairly severe recession. Note however that the nominal interest rate on the ten year Treasury bond exceeded 6% during this time. Five to ten years later, interest rates reached a cyclical peak, inflation also peaked and then declined and real returns reached an all-time high.

"The last time the US Treasury market offered a similar negative real return was from approximately 1974–1976."

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Something Has To Change, continued

> "There are three possible outcomes to today's negative yield dilemma."

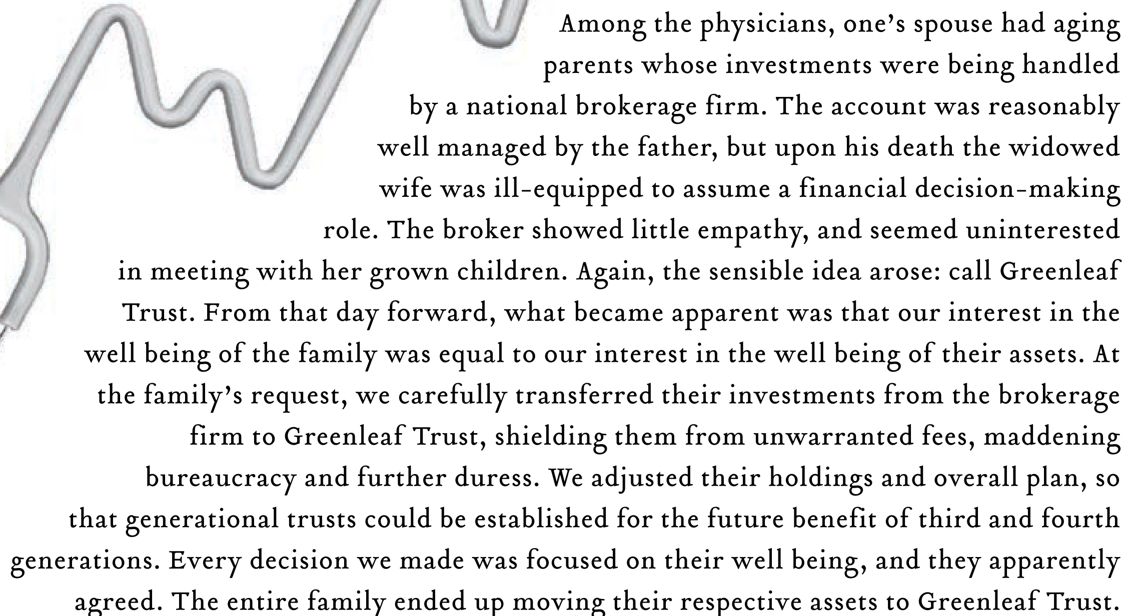
There are three possible outcomes to today's negative yield dilemma. One way to return to the normal average positive real return would be for interest rates to stay the same, but the economy falls into recession and we suffer dis-inflation. This is not our view of what is likely. A more likely scenario is that the economy continues modest improvement; investors become less afraid of equity valuations and gradually withdraw money from the low returns in the bond market. Finally, it may really be "different this time" in that lack of bond supply could be a long-term theme and it may be a protracted period before the bond market offers positive real returns since mortgage bond, municipal and even corporate bond issuance could be well below historical levels.

From today's multi-decade low bond yields, it is difficult to project historically average real and nominal returns from fixed income investments. Greenleaf Trust continues to work with clients to understand this reality, to examine the role of fixed income in their portfolios and to review appropriate asset allocations. We have positioned fixed income portfolios to take minimal duration risk since the rewards of long duration portfolios are minimal.

Doctor's Orders: Lower Stress, Higher Returns.

The medical practice had the familiar hallmarks of an investment quandary. Its physicians were highly educated, respected, successful and accustomed to calling the shots. Including where and how to invest wealth—their own, as well as their practice's 401(k). But being a first rate doctor (or any other high level professional) doesn't always translate into being a first rate wealth manager. So unconfident were some about the wisdom of their investments that they were checking their stocks between surgeries.
Talk about short-term positions.

Someone had a sensible idea: call Greenleaf Trust. We met with the doctors, introduced them to our client-centric team model, and described in detail our holistic approach to wealth management. Within days, many had become clients and we were asked to manage the practice's 401(k). Over time, we repositioned their investments so as to properly diversify and better position their portfolios for growth potential. All's well that ends well, you might say, but there's another chapter to this story.



Among the physicians, one's spouse had aging parents whose investments were being handled by a national brokerage firm. The account was reasonably well managed by the father, but upon his death the widowed wife was ill-equipped to assume a financial decision-making role. The broker showed little empathy, and seemed uninterested in meeting with her grown children. Again, the sensible idea arose: call Greenleaf Trust. From that day forward, what became apparent was that our interest in the well being of the family was equal to our interest in the well being of their assets. At the family's request, we carefully transferred their investments from the brokerage firm to Greenleaf Trust, shielding them from unwarranted fees, maddening bureaucracy and further duress. We adjusted their holdings and overall plan, so that generational trusts could be established for the future benefit of third and fourth generations. Every decision we made was focused on their well being, and they apparently agreed. The entire family ended up moving their respective assets to Greenleaf Trust.

We're the first to say not every investment strategy needs a second opinion. But with client satisfaction rates approaching 100%, and our unwavering focus on integrity and trust, it is safe to say our clients feel better about their financial health. Call us if you'd like to learn more.
We'll gladly make a house call.

GREENLEAF® TRUST

Financial Security from Generation to Generation

Carlene R. Korchak, CTFA
Vice President
Trust Relationship Officer

Last Call?

As you probably know, provisions in the current tax law known as the "Bush tax cuts" are set to expire at the end of the year unless Congress and the President enact new legislation. Tax rates for marginal income tax brackets, capital gains, dividends, gift and estate tax (and their exemption amounts) are some of the categories that will be impacted in 2013.

I recently attended the Notre Dame Tax and Estate Planning Institute where speakers from all over the country who are true experts in their fields were asked for their prognostications about what would be happening related to tax law in the new year. To a person they all said, "We don't know. Anything, or nothing, is possible." This was an interesting contrast with their comments in September of 2009 when most indicated that Congress would surely act prior to the end of that year when the estate tax was due to expire. Lo and behold, nothing happened. Then, with traditional low expectations for results from a lame duck Congress session at the end of 2010, there was a flurry of activity and results. An extension of the tax cuts through 2012, including some real changes to estate tax law, were enacted in a very short period of time. These are very different results from two election years in very recent history. So what is a person to do?

"… the "Bush tax cuts" are set to expire at the end of the year unless Congress and the President enact new legislation."

Some Planning Ideas

First, every circumstance is different so it is important to know the rules and then apply the facts to each situation. At Greenleaf Trust, we pride ourselves on taking a customized approach to each client's situation, and work closely as part of a team with the client's CPA and attorney to derive an appropriate plan. We strongly recommend consulting with appropriate advisors prior to implementing any plan. Following are some ideas we have recommended in particular situations this year.

The combined gift and estate tax exemption this year is $5 million, the highest level it has ever been. If new legislation is not enacted, that exemption will be reduced to $1 million in 2013. The gift and estate tax rates in 2012 are 35% on the amount over the exemption amount; those tax rates are set to increase to 55% next year. We have encouraged clients who can afford to do so to gift as much as they are comfortable doing this year. Depending on the situation, such gifts might be directly made to individuals or charity, accomplished through various types of irrevocable trusts, and funded with specific types of assets to reduce income tax. For those funding 529 Plans for children's or grandchildren's higher education, there is a provision in these plans that allows for five years of gifts (a maximum of $65,000 this year) to a Plan in one year, followed by no gifting for the next four years. This may be the year to "load up" those contributions which, in turn, reduces the value of the donor's estate and

allows the assets to grow tax free.

With income tax rates scheduled to increase on marginal tax brackets in 2013, this might be the year to convert all or a portion of a Traditional IRA to a Roth IRA. There are many potential pitfalls to be considered with Roth conversions, so attention to details and prior consultation with a tax advisor is strongly recommended. Generally, the conversion amount is considered ordinary income and tax will be required on the amount converted to the Roth IRA, however that tax rate may be lower this year than next. Also, distributions from a Roth IRA are not considered taxable income, and are not required until the death of the account owner. For those who believe future income tax rates will be higher when their Traditional IRA distributions are required beginning at age 70 ½, it might make sense to convert to a Roth IRA gradually, in amounts to maintain total income in the same marginal tax bracket. An added benefit to this process is that there is time to reverse the conversion (prior to timely filing of the tax return) by "re-characterizing" and moving the assets from the Roth back to the Traditional IRA, with no tax due on the conversion. This gives some flexibility in case new tax legislation is enacted, or if market conditions deteriorate.

For those with substantial positions in low cost basis stock, we consistently recommend a diversification plan. That plan usually spans several years to help mitigate the capital gain tax bill in any one tax year. With federal capital gains tax rates scheduled to increase from 15% to 20% in 2013, and a new surtax that applies to certain individuals starting next year (described below), this might be the year to accelerate a diversification plan.

While time is growing short, there is still time to consider and execute any of these techniques prior to the end of the year. One of the most challenging aspects is to consider whether or not tax law changes will be enacted, and to plan appropriately based on a wide range of possibilities.

A New Tax

Now that the Supreme Court has affirmed the constitutionality of the Affordable Care Act, there is a new tax on the horizon for 2013 income (not related to the extension of existing tax law) that will apply to certain individuals. This 3.8% surtax will be applied to the lesser of net investment income or modified adjusted gross income (MAGI) earned in excess of a certain level. The threshold amount for single tax filers is $200,000 or more, and for a married couple filing jointly the amount is $250,000 or more. Again, this is a tax applicable to 2013 income which will be paid on tax returns due April 15, 2014.

"Modified Adjusted Gross Income" includes "Adjusted Gross Income" as reported on the personal income tax return (Form 1040) with certain deductions added back. These include such items as deductible IRA contributions, student loan interest, qualified tuition expenses, foreign earned income exclusions, and others. "Net investment income" includes such categories as interest, dividends, capital gains, annuities, rental income, royalties and other passive income. Investment income does not include wages, IRA or qualified plan distributions, municipal bond interest, gains from the sale of a principal residence, life insurance proceeds, or social security income.

Obviously, strategies to reduce MAGI or net investment income below the threshold can be beneficial in this situation. Some techniques to consider include contributions to qualified plans such as IRAs and 401(k)s (annual limits apply), investing in real estate investments with depreciation calculations that reduce income, funding charitable remainder trusts which defers recognition of income over time, funding charitable lead trusts which allows for a charitable deduction, and recognizing capital gains in 2012 as noted above. The key is not to let the "tax tail" wag the dog, and to assure that such techniques make sense in an individual's overall investment and estate plan.

Understanding all of the "moving parts" and how they relate to individual situations is complex in its own right, not even considering the options for change in the near and longer term. We are pleased to assist our clients in the planning process, with "issue spotting," and with keeping current on tax legislation. Please contact us if we can help.

Stock Market Pulse

Index	9/30/12	% Change Since 12/31/2011
S&P 1500	331.68	16.13%
DJIA	13,437.13	12.23%
NASDAQ	3,116.23	20.65%
S&P 500	1,440.67	16.44%
S&P 400	989.02	13.77%
S&P 600	468.00	13.81%
NYSE Composite	8,251.00	10.35%
Dow Jones Utilities	475.75	5.58%
Barclays Aggregate Bond	112.45	3.78%

P/E Multiples	9/30/12
S&P 1500	14.1
Dow Jones Industrials	13.2
NASDAQ	16.8
S&P 500	13.8
S&P 400	16.7
S&P 600	18.1

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.11%
T Bond 30 Yr	2.83%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	331.68	14.1x	2.06%
S&P 500	1,440.67	13.8x	2.14%
DJIA	13,437.13	13.2x	2.49%
Dow Jones Utilities	475.75	NA	3.91%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.77%

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