GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

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William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

In recent weeks I have had several clients ask me about ISIS or ISIL and the attending risks to the global, and therefore United States, economy. As I stated last month this issue is much more difficult than the Russian Ukraine border and territorial conflict, and thus deserves a separate analysis. To fully understand where we are, and what the potential disruption is, we need to spend some time on history.

While I won't attempt to explain the Muslim faith, there is a good deal of the history of the Muslim religion that is central to today's conflict and its very difficult solution. The conflict between the Shiites and Sunnis is about 1400 years old, so if we expect a near-term resolution we are setting ourselves up for disappointment. The original divide began in the year 632, when the prophet Muhammad died. As with any void of leadership and power the vacuum will be filled, the question is by whom, which ultimately answers the question of who gets and who loses power.

Some believed that the next prophet must come from Muhammad's descendants (to become Shiites) and some believed that the next leader (Caliph not Prophet) must be recognized as the closest to Allah or the most divine and elite religious leader (Sunni).

The Sunnis prevailed and chose the first Caliph. As you might have surmised, the Shiite did not go away quietly — soon war emerged, Caliphs were killed and the 1400 year split between the two sects began in earnest. There are about 1.6 billion Muslims in the world today, and Shiites represent only about 10 – 15 percent of all Muslims yet they make up about 80 percent of the Muslims that are native to the oil rich Persian Gulf region where there is oil in Iran, Iraq and eastern Saudi Arabia. Many people ask "Can you tell a Sunni from a Shia or Shiite?" Not from a physical standpoint, much like you would be hard pressed to tell a Northern Ireland Catholic from a Northern Ireland Protestant. There are subtle differences with respect to the wearing of beards (length) and clerics clothing, but over the length of history the differences are aligned with geography, residence, neighborhoods and places of worship as well as the structure of religious leaders.

Shiites are led by Imams, whom they revere and are led by to the degree

Commentary, continued

that they can and sometimes do attach divine status to. Sunnis believe that this attachment of divine status to Imams is a sin, and places humans on a similar plane with Allah. Shiites are led by Caliphs who they believe lead them in purity but who are not divine. As with all religions there are conservative, moderate and liberal interpretations of Islam, and there are extreme practitioners and believers within each divide or sect. There is, of course, much more to Islam but that is about all we presently need to know about the original historical split to understand the new ISIS (Islamic State of Iraq and Syria) or ISIL (Islamic State of Iraq and Levant), which is what our US military and State Department refer to or IS (Islamic State), which is what our enemy defines itself as. By way of explanation, Levant is a geographical area which includes parts of Syria, Iraq, Saudi Arabia and Iran. For our discussion we will use ISIL, as the origin is really around a region that was heavily occupied by a Sunni population that was not defined by artificial borders established through colonization.

"The 1400-year divide between the Shiite and Sunni was widened as each sect feared the other and reconciliation efforts… were left to drift into the wind."

Why has ISIL come to power now? The answer is, in the main, due to opportunity created by oppression, graft, voids of leadership, rampant unemployment, diminished hope and the elimination of dominant political forces. Current leadership of ISIL can be traced to al-Qaeda in Iraq or AQI. After the 2003 Iraq invasion, AQI enjoyed success by joining several insurgency groups opposing the US and coalition forces and even controlled large Sunni areas of Iraq. Their method of governance, however, was every bit as brutal as Saddam Hussein and they soon were faced with a backlash from the more moderate Muslim Brotherhood as well as a surge of US deployed assets and troops. The result was the defeat (far more temporary than we believed) of AQI.

As the US began the turnover of Iraq to its elected government, Sunnis began to feel oppression by the Shiite-dominated government and were consistently left out of important political rule decisions. The 1400-year divide between the Shiite and Sunni was widened as each sect feared the other and reconciliation efforts initiated by US State Department and military leaders were left to drift into the wind. The ticking time bomb of religious intolerance, extremism void of legitimate national leadership, high unemployment and widespread sense of lack of progress was a fertile opportunity for the recruitment of ISIL followers.

The Arab spring of 2012 saw several dictators lose their platforms of power in Tunisia, Egypt, Libya and Yemen as well as create a still ongoing rebel insurgency in Syria. Once again ISIL leadership made great use of voids in power and the reluctance of the western world to take sides in what were for the most part internal struggles for power and, in some cases, democratic rule. It was not always easy to tell which sides were sectarian, secular or religious based, and the result was extended periods of time where the best-armed and most organized claimed the greatest power. If an extremist organization wanted to create a separate state and redefine boundaries based upon 1400 year old beliefs, the opportunity could not have been better. Oh, and did I mention that we trained and armed a good portion of those who would later become ISIL, and we also left staggering amounts of military arms and equipment in the hands of Shiites who lost ground to the initial thrust of ISIL, leaving the equipment for the victors to reinforce their newly formed but not untrained military force?

We can, and many will, debate the schedule of our wind-down in Iraq and Afghanistan as reasons for the reemergence of al-Qaeda in the form of ISIL, and each political party will use either side of that argument when it provides opportunity for political gain, but the reality is that we have not learned the lessons that should be dear to us when so many American lives have been lost in the course of these conflicts. The lesson I speak of is nation building, which is tough work and only successful over very long periods of time. When we fail at nation building after despots are dethroned, we leave fertile ground for the next despots who, in this case, are extremists trying to pull the world back to the year 632 and recraft the structure of Islam and redefine not only political but geographical boundaries in the process. Our globe's history is filled with wars created and waged in the name of religion. Tens, if not hundreds, of millions of people have been killed in the quest to conquer those that don't believe as they do. It is but one example of man's inhumanity to man. All religious zealots who kill, rape, plunder and maim do so on a platform of a superior faith. The record of history tells us that extremists rule extremely, and have an insatiable thirst for more power. They are neither benevolent nor tolerant, and in the end that is always their demise. It is a hard sell for ISIL that they are the most pure Muslims, when they kidnap and slaughter young women at a school. Their tools are horrific and their methods are barbaric, as has been played out in the media broadcasts over the last few months.

> "When we fail at nation building after despots are dethroned, we leave fertile ground for the next despots who, in this case, are extremists trying to pull the world back to the year 632…"

When you seek the most powerful office in the world, you know that if you win it you also win the task of being responsible to solve all of the horrific issues of the day, be they natural disasters or disasters created by humans. Global disasters occurring into the teeth of the political season only make the spotlight more glaring. Ronald Reagan had an obvious adversary in Gorbachev when he led the mission to have the Soviet Union release its grip on Eastern Europe. The leader was obvious and the structure political, not born of religion, and the promise for the Soviet Union was a better economy and more legitimate place on the world stage. I am not suggesting it was easier for President Reagan than President

Commentary, continued

Obama, but certainly it was quite different. It was difficult for the opposition party not to want the same outcome as President Reagan, even if they argued around the margins about the methods.

In the end, the solution for the ISIL threat must be an Arab and Islamic solution. Extremists can only lead if moderates and secular members of the affected population and religion allow them to. Where we can, we will be called upon to support those elements of the population that resist the extremism and abject hatred of intolerance.

This approach will be frustrating, and will cause many to call for traditional military responses which will be hard-pressed to provide the kinds of nation building assistance that makes it difficult for the extremists to win the hearts and minds of others.

This is a fight within Islam that has festered and been fought for 1400 years, and it will not go away quietly nor soon. The disempowered and the disenfranchised are often a new audience for new despotic leaders who offer an alternative to their current status. Fight alongside ISIL and you will be rewarded at least with food to eat for yourself and your family — how indicting it is to the Arab states that so many in that region see this as an attractive alternative to their current life. The degree of disempowerment, oppression, poverty and lack of hope — combined with the lack of nation building and a 1400 year schism in Islam — also illustrates why there is not a single or simple answer to the issue. Unfortunately, most of the rest of the world must wait for the Arab and Muslim world to lead their populations out of this destruction, while we simultaneously guard our safety, protect our borders and support the moderate voices of the world. The application of traditional military as well as political solutions will be left lacking in this fight and, therefore, we will need to be resourceful while being vigilant. The threat of terrorist activity will be elevated for a while, which will mean that global economies will be vulnerable to disruption and more, not fewer, resources must be employed to guard against disruptive attacks. To do otherwise ignores the reality and empowers the extremists, who thrive on fear.

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Leadership Teams Should Advance, not Retreat

Michael F. Odar, CFA
President

How are we going to get this done? Every September, that's the question I ask each division leader to answer regarding our corporate strategic initiatives for the upcoming year. The forum we use to engage Socratic discussion around everyone's ideas is our annual Executive Leadership Team (ELT) Advance.

Notice I did not call this our Executive Leadership Team Retreat. That's because we are not trying to go backwards, we are moving forward. Our Advance is held off-site each year at a location that removes the team from distractions and focuses everyone's attention on candor and the best way forward. This year we spent three days breaking down and collaboratively challenging each division's plan to address our corporate strategic initiatives for 2015. Those initiatives were provided to division leaders by me using themes derived from our company-wide strategic survey and thought leadership from our Executive Council (EC). Our Executive Council consists of Jim Gray, Chief Investment Officer (CIO), Tom Drews, Chief Operating Officer (COO), Dan Rinzema, Chief Client Officer (CCO), and Michael Ruchti, Chief Financial Officer (CFO).

At each Advance, there is meaningful time spent with members of our diversely talented Board of Directors. For the past two years, we have reviewed and been provided feedback on the progress made on our Key Performance Indicators (KPIs).

Finally, we also make sure there is dedicated time for team building and strengthening the trust we have in each other. We believe strongly that trust provides the necessary foundation for constructive communication and candor. This year we had the unique opportunity to showcase our acting skills on stage at the historic Barn Theatre, Michigan's oldest resident summer stock theatre whose alumni have been on Broadway every year since 1965. It's a lot easier to challenge someone's thinking in a meeting once you have had the opportunity to laugh at each other on stage.

After the Advance, the Executive Council and I spend purposeful time together assimilating the divisional initiatives into a cohesive plan that addresses our 2015 strategic initiatives. The plan is incorporated into our budgeting process and then communicated to everyone in the company at our annual Strategic Planning meeting in November.

The accomplishment over time of our strategic initiatives ensures the success of our longer term strategic plan. Ultimately, the objective of that plan is the continued growth in our capabilities and sophistication of remarkable service to existing and future clients.

> "Notice I did not call this our Executive Leadership Team Retreat. That's because we are not trying to go backwards, we are moving forward."

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

Lowering Taxes on Employer Stock — Net Unrealized Appreciation

Everybody knows that taking normal distributions from qualified retirement plans triggers income tax on the amount withdrawn. Most do not know they can qualify for favorable tax treatment on distributions of employer securities through a provision called Net Unrealized Appreciation (NUA). Simply put, exercising a NUA transaction can allow participant(s) to apply capital gains tax rates, as opposed to income tax rates, on the appreciation of employer stock. So for those individuals who are fortunate enough to have significant gains on employer stock within your retirement plan — this one's for you.

"Everybody knows that taking normal distributions from qualified retirement plans triggers income tax on the amount withdrawn. Most do not know they can qualify for favorable tax treatment..."

In order to qualify for NUA, the distribution must be generated by a total Lump Sum Distribution in a single calendar year. This means that all assets, including any non-company stock holdings, must be withdrawn in the same year. Although only company stock can be treated with the NUA provision, non-company stock can easily be rolled over into an IRA or another 401(k) plan.

To exercise a NUA transaction, company stock is moved "in-kind" into a taxable investment account. The original cost of the employer stock would then be subject to income tax but the remaining gain would be positioned to enjoy capital gains tax rates as the stock is sold.

Determining costs basis of employer stock within retirement plans can be challenging because recordkeeping systems rarely use basis information, therefore historical tracking is often fragmented and unreliable. Additionally, recordkeeping administrators often see cost basis as largely irrelevant since almost all retirement plan assets are subject to income tax rather than capital gains tax. Fortunately, most plans that offer employer securities can follow good faith methodology to ensure appropriate cost basis information is retrieved prior to NUA processing.

Surely some readers have already deciphered that being forced to pay income tax on the original cost basis of employer securities could trigger a significant income tax liability. Here is where some advanced tax planning and a twist in the tax code can be really helpful.

Basis Allocation Twist

For those looking to limit or possibly eliminate immediate taxation, rolling over the cost basis portion of the employer securities to an IRA and distributing the gains into the taxable investment account is the way to go. This basis allocation twist approach effectively allocates the basis and non-basis portion of the employer stock into the most tax efficient accounts. The tax treatment of this partial rollover technique is validated within the tax code and was also endorsed by the IRS in Private Letter Ruling 8538062, which is the only IRS pronouncement discussing this subject.

An Example

Tom's entire 401(k) account is made up of $1 million in employer stock with a cost basis of $250,000. In order to avoid immediate tax consequences, he elects to rollover $250,000 of the employer stock into his IRA and moves the remaining $750,000 in-kind to his taxable investment account. Since there is no basis to be taxed at ordinary income tax rates (all basis was rolled into the IRA), the entire transaction occurs with no tax due. Moreover, when Tom decides to sell the employer securities he will pay capital gains tax rates as opposed to the presumably higher income tax rates. Assuming Tom is a high income earner, he just saved somewhere in the vicinity of $150,000 in taxes! As they say—this is a good deal if you can get it.

As alluded to above, having a strong 401(k) administrator and tax preparation counsel is an important component of successful NUA transactions. Fortunately 401(k) administration is something we pride ourselves on at Greenleaf Trust so let us know if we can help.

> "For those looking to limit or possibly eliminate immediate taxation, rolling over the cost basis portion of the employer securities to an IRA and distributing the gains into the taxable investment account is the way to go."

Sanford C. Leestma II, CFP®
Wealth Management Advisor

Forward Progress

There are many ways to save for the various needs, wants, and desires you have in life. Figuring out the best way to save for them can be challenging. Determining your progress in achieving these goals can be just as challenging. Once accounts and investments are determined, the ongoing progress toward these goals can be measured. Previously, I wrote about the bucket or goals-based approach to investing, which distinguishes assets for different uses based on specific goals. This approach of separating assets also allows for the ability to measure your progress in a meaningful way.

Traditionally, investors have used asset allocation to meet investment goals by combining different assets into a single portfolio that is then optimized to provide the highest possible return for a given level of risk. In this instance, success is generally measured by how well that portfolio performs relative to a market benchmark and by using statistics like standard deviation to describe how volatile the portfolio may be.

While this approach has proven to be effective in helping to maximize the risk-return relationship of a portfolio, it can make it challenging to measure progress toward achieving specific goals. Instead of focusing on progress toward goals, the focus is on volatility and the fear of not reaching your goal.

"Figuring out the best way to save for [your goals] can be challenging. Determining your progress in achieving these goals can be just as challenging."

The volatility you're willing to accept for shorter-term goals, like college tuition, is likely different than that for a longer-term goal, like retirement. So rather than thinking about all of your assets as a single portfolio, the goals-based approach creates buckets for your specific goals and applies a timeframe and risk tolerance to each. Goals-based investing shifts the focus from tracking your portfolio's overall performance to providing a better understanding of what needs to be done to meet specific goals. As the progress is measured, corrective action can take place, if need be. This could entail a shift in asset allocation or saving more or less toward a specific goal.

Goals-based progress measurement can be easily achieved through the use of Monte Carlo Analysis. We utilize this statistical analysis to determine the probability of achieving your goals, based on your own specific circumstances and capital market expectations. Periodically, we perform this analysis for our clients to determine their progress toward goals. This analysis can be applied to any longer-term goal to assess your progress and to determine if any course correction is needed.

A goals-based investment strategy won't necessarily result in a return that's better - or worse - than the return achieved through a traditional asset allocation approach. However, creating buckets of money based on goals may help set priorities, remain disciplined in the face of competing demands on your money and have a much clearer picture of how well you're progressing toward meeting your goals.

Trust the Process

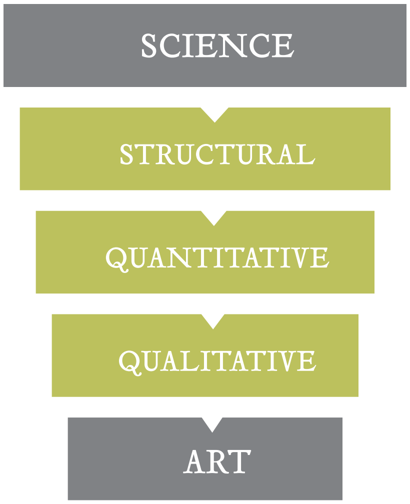
Nicholas A. Juhle, CFA
Manager Selection Analyst

At Greenleaf Trust, our in-house research team endeavors to construct robust portfolios tailored to help clients reach their unique financial goals. As a disciplined asset manager, we rely on our investment process, team approach and underlying philosophy to guide us when emotion or behavioral biases threaten to interfere with rational investment decision-making.

From time to time, short-term outcomes may diverge from long-term expectations, and this negative feedback from the market can tempt even the most seasoned analyst to abandon discipline and respond emotionally. This is especially true when investing in mutual funds, as the path to long-term outperformance often requires a healthy dose of patience along the way. In the lines that follow, I will outline our manager selection process — used to identify mutual funds — and conclude by demonstrating the importance of trusting the results of that process after the fact.

Three-Stage Approach

We believe effective manager selection requires a blend of science and art, with the scientific component focused on structural characteristics and performance statistics, and the artistic component focused on a deep understanding of the manager's investment decision-making process. Recommended managers will meet structural criteria and have a demonstrated performance track record underpinned by a logical, consistent, and repeatable investment process.



Stage 1: Structural Screening

Structural screening significantly narrows the investable universe by eliminating strategies that do not properly represent the desired exposure or do not meet prescribed thresholds for non-performance related criteria. Specific screening criteria and thresholds will vary by category, but generally include investment style, expenses, and manager tenure.

Stage 2: Quantitative Evaluation

Funds meeting structural criteria are candidates for quantitative evaluation to identify managers with a demonstrated track record of compelling performance. Quantitative evaluation narrows the field based on performance data, but stops short of determining whether historical outcomes were the result of skill (investment process, etc.) or luck. Specific quantitative screening criteria include peer relative performance rankings, risk-adjusted performance statistics, and the fund's capture profile, among others.

Stage 3: Qualitative Review

Stages 1 and 2 reduce the universe to a short list of managers with the desired structural characteristics and a compelling performance track record. Two basic questions remain: 1) Can we make a case that the established performance record was the result of skill as opposed to luck; and 2) Can we make a case that historical results will be repeatable in the future? The qualitative review is typically informed by dialogue with the manager and focuses on developing a detailed understanding of the investment decision-making process. While there are no specific requirements, the process should be logical, disciplined and repeatable in order to support both cases above. If we cannot connect our understanding of the process to the historical performance record, we will not recommend the manager.

Trust the Process

Trusting the process is critical to leveraging the work done in steps 1-3. Our selection process is designed to identify strong managers that will outperform over the long term (typically defined as over a market cycle). Given the inefficiencies (transactional, tax, and otherwise) of frequently buying and selling funds, selecting funds for the short term is not an effective strategy. This means that having followed our process, we should trust our selections and allow them the opportunity to outperform over the long term and replacements should generally only occur in the event of a material change to the manager's team, process, or approach.

"Trusting the process is critical to leveraging the work done in steps 1-3."

It's easier said than done.

Trusting the process may sound like a given, but it can be difficult. The challenge ties back to an earlier point about short-term outcomes diverging from long-term expectations – it is during these periods when remaining disciplined is the most critical. For perspective, consider an ideal outcome – suppose the funds we selected all performed in the top 25% of their respective peer groups over the last ten years. Assuming we bought them ten years ago and held them for the entire ten year period, we and our clients would be very pleased with the results.

Examining these funds more closely, the challenge becomes apparent, as 92% of these funds suffered at least one 3-year period of underperformance during the ten year span – remember these funds were among the strongest performers over ten years. Furthermore, 63% suffered at least one 5-year period of underperformance during the ten year span. This means that if our process selected a would-be top-quartile fund ten years ago, there was a 92% chance the fund would underperform for three years straight while we owned it and a 63% chance the fund would underperform for five years straight during our holding period. Consider how tempting it would be to replace a manager after three years of underperformance… after five years?

Lastly, think about what happens if and when a would-be top-quartile manager is replaced after three or five years of underperformance. Actually two things are likely to happen: 1) the manager's performance rebounds shortly after being dismissed because it wouldn't achieve top-quartile results over a decade by underperforming the entire time; and 2) the fund likely gets replaced by a manager that has demonstrated strong performance over the last three or five years, which may be just in time to take a turn underperforming. It's a vicious cycle.

> "We believe proper application of our three-stage selection process will identify strong managers… but if we abandon the results of that process amid short-term performance deviations, we all but ensure mediocre results."

Staying disciplined for our clients.

We can't guarantee that our manager selection process will always identify the next decade's top 25%, but understanding how uncomfortable the ride can be for a top performer is a huge advantage. We believe proper application of our three-stage selection process will identify strong managers capable of outperforming over the long term, but if we abandon the results of that process amid short-term performance deviations, we all but ensure mediocre results. As investors, we are nothing if we are not disciplined in our approach, which is why trusting the process may actually be the most critical step as we endeavor to help our clients reach their financial goals.

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.

Stock Market Pulse

Index	9/30/2014	Total Return Since 12/31/2013
S&P 1500	454.53	7.49%
DJIA	17,042.90	4.61%
NASDAQ	4,493.39	8.56%
S&P 500	1,972.29	8.34%
S&P 400	1,370.97	3.22%
S&P 600	634.99	-3.72%
NYSE Composite	10,702.93	2.91%
Dow Jones Utilities	551.29	15.57%
Barclays Aggregate Bond	109.11	4.04%

P/E Multiples	9/30/2014
S&P 1500	16.9x
DJIA	14.9x
NASDAQ	21.3x
S&P 500	16.7x
S&P 400	19.1x
S&P 600	19.9x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.02%
T Bond 30 Yr	3.21%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	454.53	16.9x	1.97%
S&P 500	1,972.29	16.7x	2.03%
DJIA	17,042.90	14.9x	2.15%
Dow Jones Utilities	551.29	NA	3.57%

Spread Between 30 Year Government Yields and Market Dividend Yields: 1.24%

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