GREENLEAF TRUST

Perspectives

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The Hedgehog Concept

Have you ever taken the time to reflect on who you were ten years ago? How are you different today? I have more gray hair. Then, ask yourself where do you want to be ten years from now? In 2015, we constructed our long-term strategic goal to be Top of Mind in the Michigan markets where we serve. Ten years go by fast. I believe we have been successful in most and are trending positively in a couple. At the beginning of this year, we did what I just asked above as we set out to construct our new long-term strategic goal.

We first put together a Strategy Team consisting of our best strategic thinking leaders. The charge was to critically think about who we were 10 years ago and who we are today. We then began asking ourselves challenging questions in order to define where we wanted to go. The discussions we had were real, robust, and filled with candor. We also involved input from our executive leadership team, our board of directors as well as from focus groups within the company.

As part of this process, we leaned into a strategic planning tool developed by Jim Collins, *Good to Great* author, to guide us. It's called the Hedgehog Concept and was adapted from an ancient Greek parable. According to the parable, the fox is hungry, cunning, and curious. As he tries to catch and eat the hedgehog, he uses many different tactics. The fox is constantly defeated because instead of knowing many things like the fox, the hedgehog knows one big thing – to curl up into a ball with his spikes out. Collins uses the Hedgehog Concept as a metaphor for business strategies. He argued that companies that focused on one core strategy and stuck to it were more successful than those that were more scattered in their approach. In other words, companies that did not make the jump from good to great did not fully understand their core competency. Nor were they focused on it.

According to Collins, an effective strategic goal is built from an honest understanding of what you can be the best at. It is not simply a plan to be the best. A company's Hedgehog Concept is at the convergence of the answers to the following three questions: What are you deeply passionate about? To be sustainable, a strategic goal must align with a company's

The Hedgehog Concept, continued

core values. What can you be the best in the world at? Realistically, where do we truly excel and differentiate ourselves from our competition. What drives your economic engine? The metrics that will define our success.

"To be sustainable, a strategic goal must align with a company's core values."

I am excited to share the outcome from our work in the coming weeks with teammates and clients. Understanding the process we took hopefully will add context once we announce our new strategic goal. I am proud of the intentional work we have done in this area. It's representative of our growth over the last ten years. Our new goal is SMART – specific, measurable, achievable, relevant, and time-bound. Most importantly it is focused on what we are passionate about and built with a deep understanding of our core competency. Needless to say, we will also focus on it relentlessly over the next ten years.

Nicholas A. Juhle, CFA®
Chief Investment Officer

Economic Commentary

The Federal Reserve's dual mandate, full employment and price stability, is a dynamic balance that requires constant attention. Supported by a hot labor market, the Fed raised interest rates from 0.00%-0.25% to 5.25%-5.50% over the 16 months ended July 2023 and held them there for over a year. Over that entire time, the priorities were inflation reduction and returning the labor market to a better balance between labor supply and demand. While the battle is never over, inflation fell precipitously from a peak of 9.1% in June 2022 to 2.4% in September 2024.

By the third quarter of 2024, with much of the heavy lifting on inflation complete, policymakers began to take note of a degree of deterioration in the labor market. While the job market had not become soft, it had clearly softened from an overheated starting point. In July, the Fed signaled a pivot for the committee's focus by changing language in the July Fed statement to indicate the FOMC would be "attentive to the risks to both sides of its dual mandate" (inflation and labor market) compared to "highly attentive to inflation risks" previously. In September, the Fed cut interest rates by 0.50%, lobbing some support at the labor market in pursuit of the elusive soft landing.

With policy actions at the Fed shifting from tightening to loosening monetary policy, we thought now would be an ideal time to add historical context to the current anticipated rate cutting cycle. We analyzed the latest 15 cutting cycles, and, in this article, we will share perspective on potential similarities and differences in today's outlook.

Historically, the Fed has often been behind the curve with policy moves.

Not that it's always their fault. Sometimes, unpredictable or exogenous events force the committee to be reactive. This time around, the Fed has the luxury of adjusting policy proactively and may be ahead of (or at least on) the curve for the time being. If that is true, it could mean the path ahead will play out differently than the historical experience.

In past cutting cycles, policymakers have reduced interest rates by an average of 4.70% over a period of 12 months. The bond market expects the current cutting cycle to extend through early 2026 with rates declining from a cycle high of 5.50% to 3.50% (2.00% in total cuts). In other words, investors are expecting the Fed to implement fewer cuts over a longer period – perhaps a reflection of the reactive nature of past cutting cycles.

The S&P 500 historically performed slightly better-than-average in the 12 months following the first rate cut. Returns in the six months leading into the first rate cut have been lower-than-average typically, but the S&P 500 returned 10% in the six months leading to the September 2024 rate cut. This reflects investors' expectation that US large cap earnings will continue to grow.

"We analyzed the latest 15 cutting cycles, and, in this article, we will share perspective on potential similarities and differences in today's outlook."

Speaking of earnings, S&P 500 earnings per share have declined by an average of 4% in the 12 months following the first interest rate cut. Historically, interest savings were not enough to overcome the impact of slower economic activity that tends to precipitate a rate cut. However, looking ahead, consensus estimates are for S&P 500 earnings per share growth of 13% on a forward 12-month basis, which would require a significant downward revision for a negative outcome.

In terms of GDP growth, historically the Federal Reserve begins cutting rates during a relatively positive economy, with real growth averaging 2.7%. Real growth has tended to slow during rate cutting cycles as monetary policy impacts growth with a lag. Accommodative policy may help the economy recover but, historically, it has not staved off real GDP declines. As of Q3 2024, the economy has grown at a 2.8% real rate with little evidence of an imminent slowdown.

Inflation has typically declined during rate cutting cycles. As mentioned earlier, the economy has made a lot of progress on inflation, which currently registers 2.4%. It is common for the Fed to begin cutting rates prior to achieving their inflation target, with rate cuts in 1995, 2001, and 2007 all coinciding with inflation above 2%. Inflation forecasts are steady for the near-term with expectations of 2.3% by the time the Fed is expected to complete this rate cutting cycle in early 2026.

As for jobs, past cutting cycles have coincided with rising unemployment. In the past two cycles, the Fed hit the zero lower bound prior to the peak unemployment rate which in both cases reached double digits. In this cycle, forecasters anticipate a mild rise in unemployment to

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Economic Commentary, continued

4.3%. The October jobs report, heavily distorted by strike activity and two major hurricanes saw the slowest growth in payrolls since 2020, though the unemployment rate held steady at 4.1% while jobless claims have remained historically muted.

Payroll gains tend to turn to job losses during rate cutting cycles as the Fed responds to labor market weakness with more accommodative policy. In the current cycle, payroll gains have been stronger than at the start of four of the past five rate cutting cycles, signaling that the Fed is seeking to act before significant weakness emerges. A deteriorating labor market is one of the key risks to the economic expansion and we will be closely monitoring monthly jobs reports and weekly unemployment insurance claims.

"Time will tell if this favorable backdrop evolves as expected..."

Summarizing the outlook, investors and forecasters expect a mild rate cutting cycle in the context of low and stable inflation, a slight deterioration in unemployment despite steady payroll gains, and continued strong corporate earnings growth. Time will tell if this favorable backdrop evolves as expected, but as it stands, economists place a 25% likelihood on the prospect that the U.S. will enter a recession in the next 12 months. I like those odds. And while there are nascent indications of a slowdown, the prospect of avoiding a recession in the year ahead seems reasonable absent a significant Fed misstep or other exogenous shock.

At the end of the day, we build investment solutions with business cycles, recessions, geopolitical conflict and even black swan events in mind. We manage risk with diversification, discipline and the benefit of a long time horizon. Despite an ever-changing landscape, our disciplined approach and long-term orientation serve us well as we endeavor to create comprehensive investment solutions that help our clients reach their financial goals.

The Silent Treatment: Navigating Michigan's Undisclosed Trust Law

Regina Jaeger, CFP®, CTFA
Vice President, Northern Michigan Market Team Lead and Senior Trust Relationship Officer

Michigan Trust Code (MTC) is a uniquely Michigan comprehensive body of laws governing the creation, administration, and termination of trusts in Michigan. This framework is designed to promote transparency and protect the interests of all parties involved. The MTC works in conjunction with the trust instrument (or document) to achieve the common goal of executing the trust's provisions within the legal framework established by law. Essentially, a trustee is obligated to adhere to the instructions outlined in the trust instrument while simultaneously complying with the regulations set forth in the MTC to fulfill the objectives defined within the trust instrument.

As a corporate trustee, Greenleaf Trust relies extensively on the MTC to uphold its fiduciary duties. The MTC provides default rules for trust administration, which may be modified by the trust instrument, except for mandatory provisions that cannot be altered. One such provision mandates that a trustee keeps qualified current and remainder beneficiaries of a trust reasonably informed of their beneficial interest in the trust. This obligation requires trustees to provide the beneficiaries with information regarding the existence of the trust, a copy of the trust instrument, and an accounting of trust assets on a periodic basis – requirements that remained in effect until February 21, 2024.

On February 21, 2024, a new section was added to the MTC through Michigan's omnibus bill, allowing trusts to include provisions that permit them to remain undisclosed to qualified beneficiaries for a maximum period of 25 years, creating what is commonly referred to as "silent trusts." While this legislation is new in Michigan, several other states, including Alaska, Delaware, Nevada, New Hampshire and South Dakota, have previously enacted similar silent trust statutes. These states have recognized the potential benefits and challenges of silent trusts, allowing grantors greater flexibility in managing their estate plans.

"While this legislation is new in Michigan, several other states, ... have previously enacted similar silent trust statutes."

There are numerous reasons why a grantor may prefer to keep a trust undisclosed to beneficiaries. A common concern expressed by clients considering an undisclosed trust is the fear that revealing the trust and its assets may lead to a lack of motivation in heirs, potentially fostering a sense of entitlement that can hinder personal growth. Other motivations may include the beneficiary's history of gambling or other addictions, mental health challenges, difficulties in financial management, privacy concerns, asset protection issues, or simply the desire of the grantor to

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The Silent Treatment: Navigating Michigan's Undisclosed Trust Law, continued

maintain control long after the grantor has passed. Such factors often reflect the grantor's deep understanding of family dynamics and individual circumstances.

While the option of establishing an undisclosed trust can be appealing, it is essential to carefully consider and study the potential challenges that may arise, including:

- Increased costs associated with the preparation and administration of an undisclosed trust, due to its complex nature requiring meticulous legal, financial planning and administration that may demand additional expertise.
- The identification of a designated representative, or trust director, that will represent and bind the beneficiaries during the silent period, along with the level of oversight required to ensure accountability and transparency.
- The implications if the undisclosed trust is disclosed to a beneficiary due to tax reporting requirements, which could adversely affect the trustee-beneficiary relationship that reaches beyond the undisclosed trust provisions and create potential conflicts.
- The potential for legal challenges arising from the lack of transparency during the undisclosed period, which could lead to disputes among family members or beneficiaries who may feel marginalized.
- The critical importance of selecting a trustworthy and competent trustee to mitigate the risks of abuse associated with actions taken "behind the curtain", ensuring that all fiduciary duties are fulfilled with integrity.
- Possible increased tax liability when income and capital gain generated by trust assets are retained rather than distributed to beneficiaries.

"...it is essential to carefully consider and study the potential challenges..."

While ongoing legislative efforts aim to enhance the MTC by modernizing and clarifying its framework for creating, administering and terminating Michigan trusts, it remains to be seen whether the introduction of MCL Section 700.7409a – allowing the formation of undisclosed trusts – will prove beneficial or lead to abuse and increased trust litigation. Although undisclosed trusts may offer significant advantages in terms of privacy and control, they necessitate careful planning and professional management to ensure their effective operation without complications. It is advisable to proceed cautiously and collaborate closely with a qualified estate planning attorney well-versed in the new MTC statute regarding undisclosed trusts, thereby minimizing potential difficulties for both trustee and beneficiaries while safeguarding the grantor's intentions.

Passive Aggression: Actively Wielding Index Funds

Jamie Botsko, CFP®, AIF®
Family Office Wealth Advisor

Over the past 20 years, I've been involved in a lot of discussions trying to determine the best use-case for either active management or passive investing. This conversation has taken place in institutional client boardrooms, investment committee meetings, and in living rooms with individual investors. In almost every case, the discussion centered around the "passive" concept with proponents focused on lower fees, and detractors focused on the unmanaged and unsupervised nature of the style. These arguments have a lot of nuance and can be equally compelling when reviewing a particular fund. What is important to note, however, is that building a portfolio that incorporates passive investment vehicles requires active fiduciary care and diligence; it is neither unmanaged nor unmonitored.

What are Passive Investments?

Passive investing has been around since the 1970s, with John Bogle creating in 1975 what would become the Vanguard 500 Index Fund. Passive funds attempt to track the performance of a benchmark index by replicating the basket of assets monitored by the index. For instance, an S&P 500 index fund would seek to own the 500 companies of the S&P 500 at the same allocation as the index. There are many such passive vehicles tracking a variety of indexes in both equity and fixed income markets around the world. In the case of fixed income markets, replicating the index name for name can prove difficult due to the size of the markets, so passive strategies often replicate the characteristics of an index through a representative basket of securities. In all cases, passive investments are meant to look like the index, generating similar returns for similar risk. Unlike actively managed investments, they are not designed to beat their individual benchmark. Active funds rely on the knowledge and skill of a portfolio manager to use a security selection process in determining the best names to use to beat a benchmark index. Passive funds simply aim to "be the benchmark."

> "…passive investments are meant to look like the index, generating similar returns for similar risk."

There tend to be two main vehicles for passive investing: mutual fund securities and exchange-traded securities. Exchange-traded securities have become increasingly popular for a variety of reasons, and they are quickly approaching the size of some of the bigger mutual funds. However, Vanguard maintains two of the largest index mutual funds, and they are still three times larger than similar exchange-traded securities. Choosing between these different vehicles comes down to purpose and

fit. However, exchange-traded securities are often more tax efficient for owners, resulting in lower capital gains distributions than mutual funds. The biggest technical difference between mutual funds and exchange-traded securities is in how they trade. Mutual funds trade once daily, at the closing price. Exchange-traded securities trade throughout the day.

Using Passive Investments

Passive investments have become an indispensable tool for generating risk-adjusted returns in portfolios. While there is ample room for actively managed funds within any given portfolio, many actively managed funds have struggled to keep up with their respective benchmarks over the last ten years. Active managers have the difficult task of identifying winners and holding them while also avoiding the losers that create drag on performance. Missing a winner or a loser can have dramatic effects on the success of the strategy. Passive funds do not have this element of risk. They will achieve a benchmark-like return. Any underperformance is a structural phenomenon, with fees or expenses causing the issue, not market behavior. However, with passive investments, outperformance of the market is not in the cards. They simply achieve benchmark-like returns, no more, no less.

"a portfolio manager makes active decisions about when to employ a passive fund as opposed to an active fund."

Passive investments stay closer to the benchmark consistently, always adjusting to look like the index, smoothing returns out over the timeframe and lending a degree of regularity to the returns. It is this consistency in the form of low tracking error to a benchmark that allows a portfolio manager to improve risk-adjusted returns in an overall portfolio. Essentially, a portfolio manager can maximize return per unit of risk by identifying the markets best suited to active or passive investment vehicles.

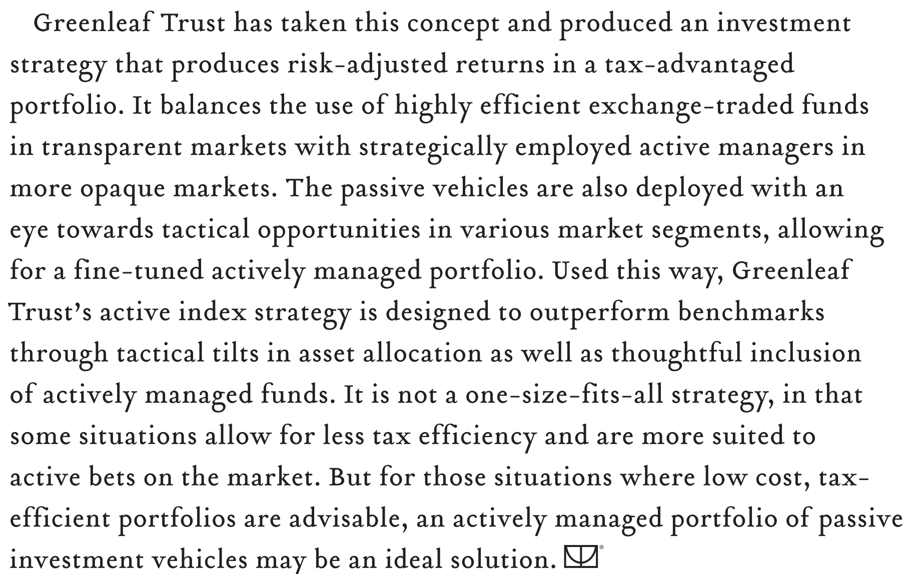
The important thing to note is that a portfolio manager makes active decisions about when to employ a passive fund as opposed to an active fund. This is the first element of monitoring and actively managing a passive strategy. While the funds employed may be passive, they are not "set it and forget it" types of investments. Rather, there is an ongoing decision-making process that identifies the best time to remain passive and when to employ more active managers. In a particular environment, portfolios could lean more towards indexing, and in another, a tactical choice around active managers might cause shifts in allocation. While the funds in use may be passive, the manner in which they are used is most certainly not!

The second element of monitoring and actively managing a passive portfolio strategy is in the asset allocation across the portfolio. A portfolio might be benchmarked to the S&P 1500, for instance, which

has a measurable allocation to large, mid, and small domestic companies. A portfolio manager could choose to construct a portfolio based on these component pieces, choosing a passive fund for large company exposure, another passive fund for mid company exposure, and a third for small company exposure. These funds could be deployed in an exact replica of the S&P 1500 allocation, but it is far more common to see a portfolio manager deploy the funds in a combination of overweight and underweight positions to take advantage of the tactical opportunities in the market. In essence, while the investment vehicles may be passive, the asset allocation is artfully managed. The result is an actively managed passive portfolio.

> "In essence, while the investment vehicles may be passive, the asset allocation is artfully managed."

Greenleaf Trust's Active Index Strategy



Greenleaf Trust has taken this concept and produced an investment strategy that produces risk-adjusted returns in a tax-advantaged portfolio. It balances the use of highly efficient exchange-traded funds in transparent markets with strategically employed active managers in more opaque markets. The passive vehicles are also deployed with an eye towards tactical opportunities in various market segments, allowing for a fine-tuned actively managed portfolio. Used this way, Greenleaf Trust's active index strategy is designed to outperform benchmarks through tactical tilts in asset allocation as well as thoughtful inclusion of actively managed funds. It is not a one-size-fits-all strategy, in that some situations allow for less tax efficiency and are more suited to active bets on the market. But for those situations where low cost, tax-efficient portfolios are advisable, an actively managed portfolio of passive investment vehicles may be an ideal solution.

Pension Plan Termination Time?

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

In the current economic climate, characterized by rising interest rates over the last two years, many private sector companies are re-evaluating the sustainability of their defined benefit (DB) pension plans. Terminating a DB pension plan can be a prudent decision for employers seeking to mitigate financial risks and enhance long-term fiscal health. To be sure, the idea of terminating DB plans is not new, as more than $300 billion in pension plan liabilities have been transferred to insurance companies since 2012. However, this decision requires careful consideration of the current interest rate environment, plan funding status, and broader economic factors.

Maintaining a DB pension plan is expensive and administratively complex, requiring ongoing contributions, actuarial assessments, and compliance with regulatory requirements. In addition, employers are responsible for meeting pension obligations regardless of investment performance or economic conditions. By terminating the plan, employers can shift the responsibility for future retirement benefits away from the company and reduce the potential for future pension deficits that could arise due to market downturns or rising life expectancies.

"...this decision requires careful consideration..."

A DB pension plan promises employees a fixed retirement benefit based on a formula that typically includes factors like salary and years of service. For employers, these plans can be costly and challenging to manage, particularly when interest rates are low. For decades, employers have grappled with the unpredictability of pension liabilities, which can fluctuate with market volatility and changes in interest rates.

Interest rate changes play a central role in the funding status of DB pension plans. When interest rates are low, the present value of future pension liabilities increases, putting additional strain on plan sponsors to maintain funding levels. Conversely, when interest rates rise, the present value of these liabilities decreases, easing the funding burden for employers.

In today's relatively high interest rate environment, many pension plan sponsors are seeing a significant reduction in the size of their pension liabilities. For example, the yield on long-term government bonds has surged over the last two years, making it easier to meet or reduce the funding requirements of pension plans. In this context, terminating a DB pension plan can be an attractive option for companies, as it allows them to "lock in" a favorable funding status, and to buyout lump sum benefits or purchase requisite annuities at lower prices.

However, terminating a DB pension plan is not a decision to be taken lightly. Companies must carefully evaluate their pension plan's funding

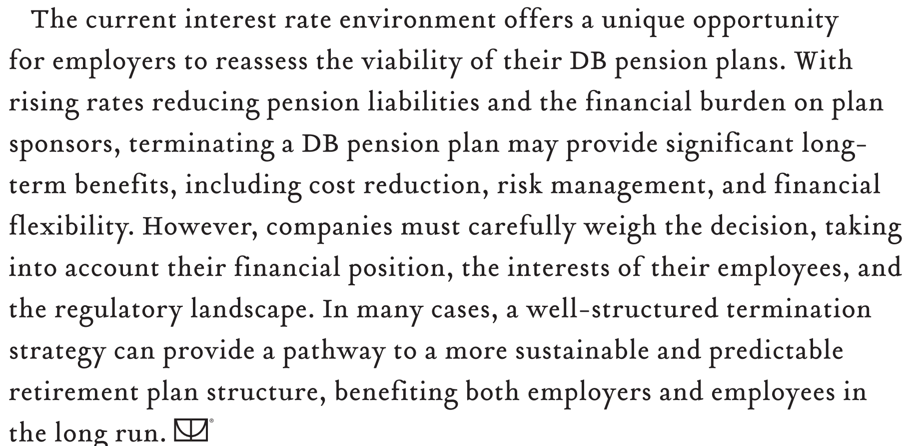
status and the impact on employees. Companies must also comply with legal and regulatory requirements, which involve significant costs in terms of plan administration and employee communication.

"Clear and transparent communication is crucial to manage these relationships effectively."

Oftentimes, annuity brokers will be called in to help plan for the necessary lump sum buyouts and select insurance provider(s) for the annuity payments to participants. This pension risk transfer process is quite involved and has implications regarding the insurance carrier(s) selected and the pension fund investment management, such as switching to a liability driven investment strategy during the termination process.

Employers should also consider the reputational and morale implications of terminating a DB pension plan. Employees who have relied on the promise of a defined benefit in retirement may view the termination negatively. Clear and transparent communication is crucial to manage these relationships effectively.

Fortunately, a DB pension plan termination can be an opportunity for employers to simplify their retirement offerings, transitioning their retirement plan contributions to defined contribution (DC) plans like 401(k)s. While DC plans shift investment risks to employees, they offer more investment choice, transparency, and control to employees.



The current interest rate environment offers a unique opportunity for employers to reassess the viability of their DB pension plans. With rising rates reducing pension liabilities and the financial burden on plan sponsors, terminating a DB pension plan may provide significant long-term benefits, including cost reduction, risk management, and financial flexibility. However, companies must carefully weigh the decision, taking into account their financial position, the interests of their employees, and the regulatory landscape. In many cases, a well-structured termination strategy can provide a pathway to a more sustainable and predictable retirement plan structure, benefiting both employers and employees in the long run.

Stock Market Pulse

Index	10/31/2024	Total Return Since 12/31/2023
S&P 1500	1,287.89	20.11%
Dow Jones Industrials	41,763.46	12.50%
NASDAQ	18,095.15	21.24%
S&P 500	5,705.45	20.96%
S&P 400	3,098.00	12.72%
S&P 600	1,383.60	6.41%
NYSE Composite	19,238.95	16.37%
Dow Jones Utilities	1,036.91	21.15%
Barclays Aggregate Bond	2,202.17	1.86%

P/E Multiples	10/31/2024
S&P 1500	25.4x
Dow Jones Industrials	22.6x
NASDAQ	39.7x
S&P 500	26.1x
S&P 400	20.0x
S&P 600	19.8x

Key Rates

Rate	
Fed Funds Rate	5.25% to 5.50%
T Bill 90 Days	4.47%
T Bond 30 Yr	4.48%
Prime Rate	8.00%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	1,287.89	25.4x	1.33%
S&P 500	5,705.45	26.1x	1.30%
Dow Jones Industrials	41,763.46	22.6x	1.79%
Dow Jones Utilities	1,036.91	24.4x	3.51%

Spread Between 30 Year Government Yields and Market Dividend Yields: 3.15%

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