Update

For the first three months of 2011 we were writing about the challenges and impact on our economy produced by the explosion of citizen unrest in Egypt, Yemen, Libya and Saudi Arabia. Financial markets react very poorly to uncertainty, and with control of oil production assets in question, the natural bias of uncertainty is to assume the worst outcome.

If geopolitical instability were not wreaking enough havoc upon global markets, the horrific tsunami that battered Japan’s coast created a one-two punch that many prognosticators suggested would be enough to destabilize many economies and send several, if not all, back to recession.

Much is yet to be understood and written about the popular uprisings in the Middle East. Democracy is not easy even when it works well, and is historically wrought with imperfections in the infancy stages of its creation. To say that a population’s political will must withstand multiple tests during the formation of representative governments is a huge understatement. Sectarian tribal and religious identities are often more important to individuals and families than national purpose and constitutional construction. Countries formed by colonization like Libya are particularly challenged in this process.

Iraq presents a real-time canvas for us to view in the democratization process. While far from perfect, they have managed to keep nationally important natural resources in the hands of the elected government. Therein lies a significant and, as yet, unanswered question for several Middle East countries. Will the transition to representative democratic governments and the reduction of monarchic and dictatorial rule be chaotic or civilized, and will that transition allow for the continuance of commerce and the dependability of supply? Without certainty of continuance and dependability, the void of factual information is filled with speculation.

Speculation is best measured in futures contract trading, and with current oil futures contracts in the $105 per barrel range, the market’s
Update, continued

“It is somewhat natural to assume that the devastation wrought by the tsunami on the world’s third largest economy will significantly impact the other developed economies of the world.”

current assumption is that continuity and dependability are not in significant question. Markets have had a few weeks to synthesize all information and, while much is changing daily and much will yet be learned and written about the new political order developing in the Middle East, for the moment the change in energy prices has, by itself, a less than material impact on our economy.

At this writing, the Japanese tsunami is but sixteen days old. As video footage emerged in the hours following the actual event, questions emerged and global markets reacted with fury. Once again, the void of information was filled by the voice of the unknowing, and speculation ruled the moment. As more thoughtful opportunities arose, and as facts replaced speculative information in our popular culture media, markets gained direction.

It is somewhat natural to assume that the devastation wrought by the tsunami on the world’s third largest economy will significantly impact the other developed economies of the world. To quantify that impact, we first must know the size of Japan’s demand on our exports and the percentage of our imports that come from Japan, as well as the impact on our automotive industry’s supply chain. Let’s try to put some numbers to these questions.

Japan represents a demand impact of 5% of our total exports. The assumption that the tsunami will have a negative impact on Japanese consumer-driven demand is most probably correct. When we peel back the onion on the make-up of our exports to Japan, we see that much of those exports are not dominated by consumer production, but rather healthcare-related exports. Assuming significant near-term interruptions to Japan’s general economy makes sense, however, the total impact on our near-term GDP is approximately ½ of 1%. The majority of that impact comes from the 6% of automotive imports in not only finished products but also supply-chain products sold into our domestic automotive supply chain.

Beyond near-term economic interruption will be the reconstruction of the devastated areas of Japan. Much of this reconstruction will require new supplies of equipment, materials and engineering processes. The lag impact on demand and actual exportation of product is real and, therefore, 2011 will see little positive impact on GDP. In summary, the near-term impact will be negative by ½ of 1%, while 2012 will see some demand impact in excess of the ½ of 1% lost in 2011.

We calculate that the current increase in energy prices, as well as
the near-term impact from the tsunami on Japan’s economy, will have a full one percent negative impact on US GDP for 2011.

December of 2010, as well as the first two months of 2011, demonstrated enough strength over previous forecasts that many economists, including Federal Reserve economists, revised their GDP forecast upward to a range of +3.5% to 4.25% for full-year 2011. Our forecast, constructed in late November 2010, modeled GDP growth at +2.9 to 3.3%. While we could sense some increase in the demand side of our economy, the implications of both energy prices and the impact of the tsunami suggest that a 3% GDP growth target for 2011 remains prudent.

Unemployment will not get much better, and interest rates are not likely to move. Equity markets seem somewhat oblivious to the GDP setbacks, and in recent weeks have ignored some pretty significant news. While this can continue in the short term, we are likely to see a more realistic connection between GDP growth and corporate earnings. No one can predict when corrections will commence, but valuations do matter and we may see that equity markets are a bit ahead of themselves as the Dow nears 13,000.

The general media appears surprised that housing is still in the tank. In the United States, we built three times the true demand for new housing product for nearly 2½ years, after which we withdrew credit and access to it. Current purchasers of new and existing housing product, if they are not cash buyers, must meet far more stringent credit requirements. Add stagnant income growth and 9% unemployment to the picture, and one can easily understand why housing stock will remain in national oversupply, with some regional pockets of growth through 2013.

This month’s newsletter required that we analyze the economic impact of natural and human disasters. We do it because it is expected and it is our profession. Calculating economic impacts of natural and human disasters cannot be done without acknowledging the human price paid to endure what nature presents in the case of the tsunami, or deaths experienced by citizens who, without weapons or power, demand that a dictator leave office. Lives are lost in both events, families devastated and children orphaned. Yes, it is true that economic inconveniences result from both. History tells us that economies and markets will endure and recover over time. Our thoughts and concerns are with those who have risked, endured and suffered.

“Calculating economic impacts of natural and human disasters cannot be done without acknowledging the human price paid... our thoughts and concerns are with those who have risked, endured and suffered”
Implications of the Crisis in Japan

The story of the earthquake and tsunami that devastated parts of Japan on March 11 is still unfolding. As the cleanup continues and the resiliency of the Japanese people is put to another test, there is, beyond the human factor, a natural wonderment about the global economic and market impacts of the event. Although no one knows for sure, and the changing information coming out of Japan makes it even more difficult, there are some preliminary conclusions we can draw.

In the wake of intensely focused transportation, production, and power interruptions, the already anemic Japanese economy, with its strong yen, aging population, and significant debt, will be negatively impacted over the near term. Considering that Japan is the world’s third largest economy, with many trading partners, there will also be a global impact, the extent of which is conjecture at this point. According to the International Monetary Fund (IMF), real global GDP growth was projected at 4.2% prior to the disaster, with Japan accounting for only 0.1% of that growth. So, although not expected to be a major contributor to global GDP growth, there would be a slight negative multiplier effect to global GDP associated with a contraction in Japan’s economy over the near term.

As of this writing, US equity markets are now above where they were prior to the disaster. This is noted with full recognition that there are certainly other geopolitical events (e.g. Middle East uprisings) that are having an impact. It seems, though, that US equity markets have already processed the near-term negative global GDP effects associated with Japan, and are looking forward using historic patterns as a guide. The markets, as indicated by their recent behavior, are probably looking forward to the reconstruction phase that typically follows the initial production and consumption disruptions to a developed economy after a natural disaster. The reconstruction phase is characterized by government spending, monetary stimulus, and insurance payouts that spur economic growth.

Although at this point not readily apparent to everyone, the markets seem to be at least hearing the right things coming out of Japan related to reconstruction. For instance, the Japanese central bank announced a significant expansion of its quantitative easing program, which similar to ours (QEII), is designed to free up capital at financial banking institutions that can then be lent out. In addition, there have been no issues with the placement of additional Japanese debt in the marketplace. There is also some preliminary evidence that overseas assets are being sold and the proceeds repatriated back to Japan by financial institutions and investors.

From all this, we think it is a...
logical conclusion that the events in Japan will continue to create more volatility in global markets. Furthermore, we think it provides another illustration that, regarding significant market events and global developments, investors are typically rewarded by discipline, fact-based decisions, and level-headed thinking. We have reviewed existing portfolio holdings from both near-term and long-term impact perspectives. In some cases, swift action has been taken, and in others we anticipate future opportunities. Target exposure to Japan in our recommended international equity allocation remains low, at 3.5% of the overall international equity allocation which includes both developed and emerging markets. Finally, our Research Team takes very seriously its commitment to making informed investment decisions on behalf of clients, and continues to aggressively keep abreast of the fluid situation around the globe. 

Joint Ownership

Many couples share ownership of bank accounts, investment accounts, real estate and personal property as joint tenants with rights of survivorship (JTWROS). This type of shared ownership arrangement, however, does not need to be limited only to a spouse. As I will discuss later in this article, ownerships as JTWROS could provide significant benefits for children and their parent(s), siblings, business partners or any organized group of people.

The Basics of JTWROS

JTWROS denotes ownership shared by at least two people, in which all owners, or tenants, have an equal right to the asset(s) and, upon the death of an account owner, the surviving account owner(s) maintain ownership. As with every planning technique, there are pros and cons to consider.

• Efficient Transfer at Death
  Because JTWROS automatically transfers ownership to the surviving owner(s) upon the death of one, it avoids the probate process. This is a particularly key advantage for those who may need continual or immediate access to funds in a bank account for example. This also means, however, that the decedent loses control over the ultimate disposition of the asset(s) at death.

• Equal Rights and Responsibilities
  When an asset is titled
When an asset is titled JTRWOS, it means that all owners have equal rights to the assets and any earnings related to the asset. They are also equally responsible for the assets, including any maintenance or related liabilities. For example, if a home is owned by a couple as JTWROS, and they take out a loan against the value of the home, they are both equally responsible for repayment of the loan. This feature could become an issue if a relationship turns sour, as with an estranged child, a divorce, or a disagreement between business partners or friends.

Financial Considerations
JTWROS ownership is typically less desirable when one of the owners has significant debt, is dealing with financial difficulties or is receiving government benefits. Joint ownership with an individual in one of these situations may lead to a reduction or elimination of their benefits, the account being frozen upon that individual’s passing while a court sorts out their assets and liabilities, or it could limit the joint owners’ ability to sell an asset or obtain a loan against the asset.

Real Estate Ownership as JTWROS
To understand the potential benefits to this type of ownership arrangement, it will help to understand the property tax assessment process. While I am referring in this article to Michigan state law, most other states have a similar process.

The Michigan General Property Tax Act (The Act) requires that real property in Michigan be assessed annually. Owners are then taxed at one-half of its market value. In 1994, the Headlee Amendment to the Michigan Constitution was passed which essentially limited how much taxes could increase each year by capping annual property tax increases at levels specified in the Act. The capping of the original taxable value remains in place until a transfer of ownership occurs. When the property ownership transfers, the property is reassessed based upon the “true cash value” as of the date of the transfer. The property’s new, and typically substantially higher, taxable value is then capped at the new amount until the next transfer of ownership takes place.

The planning opportunity lies within the definition of “transfer of ownership”. Simply defined, this means the conveyance of title to, or a present interest in,
real property. However, there is an exemption from property tax (taxable value) uncapping for a transfer that occurs upon the creation of, or termination of, a joint tenancy between two or more people. There is one key stipulation to this exemption. At least one of the joint owners needs to be an original owner of the property prior to the creation of the JTWROS, and that person needs to have remained as a joint tenant.

Earlier this month, the Michigan Supreme Court ruled on an appeal case which involved this strategy, providing a perfect example. In 2004, a father transferred a property to himself and his son as JTWROS. The Supreme Court held that this transaction qualified for the joint tenancy exemption and did not result in uncapping. In January 2005, the father passed away. Given the JTWROS arrangement, the son immediately became the sole owner of the property. The Supreme Court held that this transfer also qualified for the joint tenancy exemption and did not result in uncapping. When the son transferred the property to himself and his brother as JTWROS, this did not qualify for the exemption, because neither were the original owner prior to the JTWROS creation. This last transfer did result in uncapping.

In this example, the ownership of the property transferred efficiently upon the father’s passing and taxes were not uncapped. Had the brother been added as a third JTWROS at the time of its creation, this would likely not have resulted in an uncapping.

Using a JTWROS arrangement may make sense when there is a piece of property that has appreciated in value and the additional owners, whether family or friends, would like to maintain ownership of the property after the original owner’s passing. The original owner often maintains a life estate, allowing him or her to continue to live in the home and claim a homestead exemption.

Even in the event that the surviving joint owners decide to sell the property, they will be able to maintain the current taxable value and related property taxes until the property is sold. This benefit is particularly attractive if the home is expected to be on the market for a long period of time.

JTWROS can be a great strategy to implement the transfer of real estate to others. However, given the uniqueness of all properties, state laws, and individuals’ desires, having involvement from a tax advisor and estate planning attorney is strongly advised.

“Using a JTWROS arrangement may make sense when there is a piece of property that has appreciated in value and the additional owners, whether family or friends, would like to maintain ownership of the property after the original owner’s passing.”
Safe Harbor 401(k) Plans

Many employers recognize the benefit of providing a qualified retirement plan (QRP) for employees, and the 401(k) is easily the most well known type of retirement plan. The term “401(k)” simply refers to a subsection of the Internal Revenue Code that allows qualified employees (participants) to defer a portion of their income into a QRP. This year, those deferral amounts are capped at $16,500 for participants under 50 years of age, or $22,000 for those participants who have attained age 50. Money deposited into the 401(k) receive beneficial tax treatment—most often deferral of taxes until distributions are taken during retirement. This advantage leads many employers to agree that an employer-sponsored 401(k) plan can help to recruit, retain, and retire employees from their firm.

The goal is usually for all employees to have the opportunity to maximize the allowable benefit of the 401(k). Sometimes adopting the basic 401(k) provision is not enough to accomplish this goal. In an effort to ensure that QRPs are not simply a tax haven set up for owners and executives, legislation is in place that requires QRPs to be run through a battery of tests to confirm that the so called “Highly Compensated Employees” (HCEs) do not receive a materially higher benefit than the “Non Highly Compensated Employees” (NHCEs). More specifically, the average deferral of the HCEs can be no more than two percentage points higher than the NHCE group, or 1.25 times the NHCE average deferrals, whichever is greater.

As one would imagine, those earning less money generally save lower percentages of their pay than those with higher incomes. Handcuffing the average deferral percentage of these two groups can often lead to a problem whereby the HCEs are forced to limit their deferrals because the NHCEs do not defer a high enough percentage of their compensation.

Safe Harbor to the rescue. Simply stated, a safe harbor provision allows the employer to sidestep the nondiscrimination limits if they contribute a preset amount to all participant accounts. As we have all heard, there is no free lunch. Employer safe harbor contributions can come in the form of a match (generally totaling 4% of pay) or a non-elective profit sharing (totaling 3% of pay). Additionally, all safe harbor contributions must be 100% vested at all times, with immediate eligibility for employees. That is to say, if the employer wants to remove any HCE deferral limits, they must be willing to provide some money to all employees with no strings attached. Ample notice to employees before the start of the year is also required, eliminating the chance that a safe harbor adoption can be made haphazardly.
in the middle of the year. There are several reasons employers decide to provide contributions on behalf of employees, but the cost of providing such a benefit is almost always a consideration. The expense incurred to adopt a safe harbor 401(k) provision is largely based on participant demographics. Clearly, it is more expensive for a firm to provide a guaranteed 3% contribution to 500 highly paid participants than it would be to provide the same benefit for 25 lower paid participants. Most often 401(k) plans already involve some level of employer funding, so the decision is rarely based on comparing no employer contribution versus the entire safe harbor requirement. Rather, the employer is left to determine whether they are willing to accept the comparative funding difference and the additional stipulations mandated by the safe harbor rules (e.g. 100% vesting). A simple cost benefit analysis can help to provide a purely objective economic look at the benefits of the safe harbor design. In the real world employers must also consider subjective issues, such as the company’s level of responsibility to provide employees with employer contributions.

As always, there are many variables that go into determining an optimal retirement plan design. One of the most common retirement plan complaints revolve around HCEs (including the business owners themselves) having to limit their deferrals based on discrimination testing. Although a safe harbor arrangement might not be the right fit for all firms, it is certainly one possibility worth considering.

The Bogus IRS E-Audit

You receive an official-looking email, supposedly from the IRS. The email states that the IRS is auditing you and that you must complete and return the attached questionnaire. If you do not respond within 48 hours, the message reads, you will face penalties and interest.

The questionnaire asks for personal and financial information, such as your Social Security number and bank account numbers. Honest folks are nervous about not complying with IRS directives and respond, wanting to do the right thing. There may even be a link in the message that will take you to a fake web page that appears very official. In fact, it has been copied from the official IRS web page.

The IRS uses only the US Mail to deliver notice of an audit or a request for additional information. You should completely disregard and delete any email claiming to be from the IRS.

If you receive such a bogus email, you may report the scam by forwarding the email to phishing@irs.gov.
In a previous article, I wrote about lessons learned having lived through volatile markets. The lessons included risk management and diversification. Regarding risk management, I stated that a broad allocation, including alternative asset classes, can increase return potential and decrease volatility or risk. This statement prompts the question “What increase in return and what decrease in volatility can be expected?” To help answer this question, we turn to historical returns of different asset classes and the relationships, or correlation, between those returns.

In statistics, correlation measures the relationship between two entities over a period of time. The highest correlation of 1.0 means the two entities are perfectly synchronized. A correlation of 0.0, or no correlation, means the relationship is random. A correlation of −1.0 means the two will move in opposite directions. Reducing the volatility of returns in a portfolio is achieved by combining assets that tend to have low correlation to each other. Some assets are likely to climb when others fall, helping smooth out returns. In the long run, extreme losses in the overall portfolio will occur less frequently, and the capital will grow more.

For many investors, low correlation investing begins with stocks and bonds. We believe there are significant benefits from the addition of alternative assets to portfolios. Currently, our recommendations include the use of commodities, global real estate and the Permanent Portfolio Fund. Commodity and global real estate returns have a very low correlation with equity market returns, yet have similar long-term expected returns. In addition, a categorical diversification mutual fund, the Permanent Portfolio Fund, adds exposure to gold, silver, Swiss franc dominated assets, natural resources, and global real estate stocks. The 10-year correlation (using Ibbotson data ending in 2006) between the S&P 500 and US bonds is 0.23, and between the S&P 500 and real estate is 0.52.

The impact of alternative assets on return and range of return (standard deviation) and portfolio correlation is illustrated in a Morningstar study comparing portfolios with different asset allocations. A two-asset portfolio with equal percentages allocated to large and small US equity had an average annual rate of return of 10.74% (1970–2006), a standard deviation of 18.03%, and a portfolio correlation of 0.738. A four-asset portfolio,
including equal percentages to large US equity, small US equity, international equity, and US intermediate term bonds had an average annual rate of return of 10.6%, a standard deviation of 10.45%, and a portfolio correlation of 0.416. The addition of commodities, real estate and cash to the portfolio, with equal percentages allocated to each of the seven asset classes, had an average annual rate of return of 11.25%, a standard deviation of 8.67%, and a portfolio correlation of 0.128.

The attractiveness of an alternative, low-correlation strategy is more apparent when equity market performance is relatively weak. Constructing portfolios including the use of alternative assets in equity allocations has the benefit of smoother performance, which typically means there may be underperformance relative to an all-equity benchmark when equity markets are strong, but outperformance when equity markets are weak. As mentioned earlier, this strategy is used with the intention of limiting extreme losses while still achieving similar returns to the equity markets in the long run. The attractiveness of the strategy becomes even more apparent when there is a demand on (withdrawals from) the portfolio.

If a portfolio sustains a loss of 25% in a given year, it needs a 10.1% average annualized return over the next three years to restore its pre-loss account balance. If 5% is being withdrawn from a portfolio and a 25% loss is sustained, the needed annual return to recover in three years is 19.4%. If the loss is 10%, it only needs a 3.6% average annualized return over the next three years to restore its balance. If there is 5% being withdrawn and there is a 10% loss, the needed annual return to recover in three years is 11.5%. A 19.4% return is possible but not probable, especially three years in a row.

Low-correlating assets have shown to be beneficial to portfolios. The increase in return and decrease in volatility is quantifiable and key to portfolio asset allocation, regardless of whether assets are being accumulated or withdrawn.
### Stock Market Pulse

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### Key Rates

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<td>T Bill 90 Days</td>
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### Current Valuations

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### Spread Between 30 Year Government Yields and Market Dividend Yields: 2.63%

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