# Private Wealth *perspectives*

VERSION 21.3

INVESTMENT MANAGEMENT • FINANCIAL AND ESTATE PLANNING • PRIVATE BANKING • FIDUCIARY ADMINISTRATION • RETIREMENT PLAN SERVICES

If Shakespeare were alive today, he may re-write his famous soliloquy as "To mask or not to mask, that is the question". I have been struck by the popular media narrative of a nation divided or even confrontational over questions such as the one a modern-day Hamlet might ask. In my corner of the world, I mostly witness grown-ups having grown-up conversations about their behaviors and choices. Its refreshing and has sparked a renewed interest on my part of tuning out the noise.

As usual, our team of experts at First Merchants have crafted articles for you that separate out the noise and instead provide thoughtful and actionable insights on topics that matter to you and your family's financial wellbeing. I hope you enjoy our perspective as much as we enjoy working with all of you. Enjoy the waning weeks of summer and stay healthy, stay safe and stay positive.

Michael Joyce
President, Private Wealth Advisors

## INVESTMENT MANAGEMENT

### Transitory, Temporary, Tapering, Tightening, Treasury Notes, and other "T" Words

I've been doing investments for over forty years now, and it has always amazed me how market observers will focus on and repeat words or phrases until we all get tired of hearing them. Today's hot words are transitory, temporary, tapering, tightening, and the phrase "talking about talking about". Listen how these words are used over the next few months because these may affect the bond and stock markets. With the U.S. emerging from the largest economic shut-down in history, there is increasing talk about how this re-starting will effect economic growth, interest rates, inflation and asset values. I believe everyone (and their mothers) have heard how inflation measures have spiked up recently and the question that just about everyone is asking is whether inflation will continue to rise or if inflation will be **transitory** or **temporary**. Federal Reserve Chairman Jerome Powell has said often that he and the Fed believe the recent inflation spike will be **transitory** or short lived. Mr. Powell has said "An episode of one-time price increases as the economy reopens is not likely to lead to persistent year-over-year inflation into the future. Clogged supply chains won't affect Fed policy, Powell said, because "they're temporary and expected to resolve themselves."

In April, Mr. Powell made clear that the Federal Reserve isn't even close to beginning a pullback in its ultra-low interest rate policies. In a statement after the April policy meeting, the Fed said it would keep its benchmark short-term rate near zero, where it's been pinned since the pandemic erupted over a year ago. The goal is to help keep loan rates down, for individuals and businesses, to encourage borrowing and spending. The Fed also said it would keep buying $120 billion in bonds each month to try to keep longer-term borrowing rates low, too. At a news conference, Powell stressed that the Fed would need to see more evidence of sustained and substantial improvements in the job market and the overall economy before it would consider reducing its bond purchases.

A quote of Mr. Powell that has been often repeated is, "we are not even "**talking about talking about**" **tightening** monetary policy." However, we all knew that the time until the talking begins is drawing closer. In the past, Powell has said that the Fed's eventual pullback in its economic support would start with a reduction in its bond buying and only after that a potential rate hike. Two words that have in the past sent the stock market into shock have been **tightening** or **tapering**, meaning a slowing of its massive bond purchases. In June, the chairman responded to concerns about spiking inflation by reiterating his view that current price increases will likely prove **temporary**. However, he also said that officials had begun a discussion about scaling back bond purchases after releasing forecasts that show they anticipate two interest rate increases by the end of 2023.

Over the next several months, we may see inflation rates much higher than normal and the Fed's patience may be **tested** in terms of keeping monetary policy steady in light of surging inflation measures. Consumer prices jumped 5% in May compared to a year earlier and in June registered a 5.4% increase. Even core CPI (ex-food and energy) rose at a 4.5% yearly increase. This was the largest year-on-year in core inflation since 1991. Much of the recent increase can be tied to transportation (car and airline prices have been surging) and shelter (with housing prices and hotel lodging prices both spiking higher). Oil prices recently hit a 33-month high and lumber prices earlier quadrupled within a year. Even though lumber prices have fallen from their highs, many prices remain far above pre pandemic levels. The $100 question is how long some of these pandemic related adjustments will take to subside? Supply shortages will ease gradually, but possibly not as quickly as some hope and may continue to put some pressure on inflation. In addition, the post lock-down booms in business and residential investment will fade, but investment growth may remain strong for some time.

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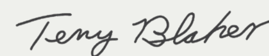
Economists say that a large part of inflation is affected by consumer perception on what inflation will be. The longer that inflation remains elevated, the more the inflationary expectations may begin to be built into consumer behaviors. Perhaps most importantly, widespread labor shortages have pushed up wage growth as many businesses struggle to staff positions with qualified workers. We believe that labor cost inflation may be stickier and may be less transitory than some of the other inflation pressures. Widespread labor shortages, in part due to longer-lasting factors such as a skill mismatch and an increase in people nearing retirement mean that wage inflation may accelerate and remain at permanently higher levels. A record share of small firms report it is difficult to find workers. The surge in job openings has been most extreme in those areas hardest hit by the shutdown such as the leisure and hospitality sector, but all sectors have seen increases. While factors such as childcare problems, health concerns and overly generous unemployment benefits are partly to blame for worker shortages, the previously mentioned, but significant skill, and location mismatches as well as an aging America are factors that won't go away. Therefore, we think wage inflation will continue for some time and hit 4% or more.

Another reason that core inflation may be less transitory and remain higher for longer is the massive amount of recent and proposed government expenditures and the huge amount of liquidity sloshing around in the banking system. While increased debt doesn't have to translate into future inflation, we remain concerned about the long-term effects of government and corporate debt on both inflation and future economic growth. While low borrowing costs mean that the cost of servicing that debt is lower than in some past periods, the net debt burden now exceeds 100% of GDP. Americans have socked away an amazing amount of savings over the last year, estimated to be close to $2 trillion above normal savings patterns. Some of this savings will be unleashed in coming months.

How will all these factors affect the investment markets? As you might expect there are differences of opinion. Many agree that consumer companies may benefit as people spend money on everything from wardrobe refreshes, to travel, to dining and so on. Medical device companies and healthcare supply companies may benefit as people go ahead with delayed elective procedures. Financial companies should benefit from a broad rise in economic activity. Stretched supply chains may mean more industrial spending. However, many observers worry that stretched stock valuations may not hold up if interest rates rise. On the other, expanding corporate profits may offset moderate interest rate increases. Despite the worries about inflation, we continue to think that interest rate increases will remain very moderate. In fact, several clients have asked why the ten year **Treasury Note** yield has fallen from 1.75% to as low as 1.20% this year. Four major reasons are: a) the huge amount of liquidity out there b) the bond market really isn't that worried about inflation, c) the rest of the developed world has even lower rates and d) short-term technical factors that I won't try to explain here. While US growth may peak in 2Q, we still forecast GDP growth of more than 6% this year and at least 5% in 2022. With a Fed taper announcement likely in the coming months and the labor market recovery set to continue as frictions ease, we expect the 10-year yield to reach 2% within the next year. What are some other reasons that the forecast for stocks might not be quite as rosy? First, market pricing leaves little room for disappointments. Second, economic growth both in the U.S. and overseas might fall short of very optimistic expectations. Third, we think that China's economy may continue to lose momentum. Fourth, inflation and/or interest rates may surprise both the Fed and markets. Fifth, the battle with COVID and its variants may linger longer than some expect, especially in the developing world. This all means that returns from risk assets may be both volatile and limited over the next couple of years.

Our advice remains to continue to diversify your investments, keeping enough in risk control assets to fund necessary expenditures for at least three years and to not chase recent performance of some assets. Finally, keep a close eye on the "T" words that I mentioned earlier. Things seldom happen just the way that the forecasters predict. Last of all, be sure to check in with your advisors at First Merchants.

Terry Blaker
Director, Investment & Portfolio Mgmt



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# WEALTH MANAGEMENT

## HOW DO YOU ADD VALUE?

This is the question you should be asking your financial advisor(s). If the answer you receive is singularly focused on investment returns, keep reading. Studies have shown comprehensive advice can add 2.00% to 7.00% in monetary value annually and some advice is essentially priceless! When considering the value an advisor provides, there are a number of areas some of which you may not often think about. In dollar terms, comprehensive advice can equate to an added $20,000 to $70,000 per year for a client with a million dollar investable portfolio. Over the years, we've analyzed many actual client cases and compared them to these studies. Here is a sampling of what we've found.

**THE VALUE OF RETIREMENT PLANNING**. Portfolio tax strategies and income sourcing can add .50% to .70% annually to your bottom line. Of course, maximizing Social Security benefits can add thousands of dollars of value over time. But, determining when you can stop working can be truly priceless. Case in point – we were advising a married couple on their overall financial plan. The husband was the head of emergency medicine at a large Midwestern university hospital and the wife was a nurse practitioner. They had been financially responsible, but were having trouble understanding if and when they could retire. As we reviewed the financial analysis with them and shared the fact that they reached financial independence, the wife began to cry. We knew they had two special needs adult children. She shared that from the day they were born, she never thought they would have enough money to leave them. We had just shown them that even if both of them passed away that day, not only would their children be taken care of, but their portfolio would continue to outpace projected expenses. We gave her something she never thought possible - financial peace of mind.

**THE VALUE OF ESTATE PLANNING.** It's no secret that having estate documents, such as a will or trust, is very important. Dying without a will leaves decisions about your assets to someone else, typically a judge. With estate tax exemption amounts at $11.7 million per individual in 2021, most people believe there isn't any need for this type of planning. That's simply not true. Avoiding probate can equal avoiding thousands of dollars in settlement costs and attorney fees, not to mention time savings. Two areas we audit with our clients are estate income taxes and ensuring that assets go where they are intended. We recently disbursed a seven figure IRA because of the death of the owner. The beneficiary designation recommended by legal counsel resulted in roughly $100,000 more being paid in income taxes. While certain beneficiary designations can make sense in some situations, it is important to review the estate plan in the context of each client's overall financial situation. This includes considering the heirs' tax brackets and family dynamics. In this case, the choice of beneficiary designation cost each heir approximately $11,000 in taxes.

**THE VALUE OF INVESTMENT PLANNING AND BEHAVIORAL COACHING.** Many advisors believe they are great stock pickers. Experts have taught us that many are not. So where do we get value in investment planning? There are the obvious places. For example, selecting lower cost investments can save 0.45% to 0.82%. Tax loss harvesting, which is strategically selling securities at a loss to offset a capital gains tax liability, can add as much as 0.20% to 0.80%. Rebalancing regularly can add another 0.35% to 0.44%, while appropriate diversification reduces risk. But what happens when emotions run high? Average investors often make decisions that impair returns and run counter to their long term objectives. Emotions, fear or unchecked enthusiasm can undermine a disciplined approach which is essential to successful investing. Financial advisors who take a long-term and comprehensive approach are essentially your emotional circuit breakers. Taking a dispassionate approach in service to your overall goals, risk tolerance and risk capacity is crucial. Emotional decisions however, can lead to speculation rather than sound investing.

Another important aspect of investing is asset location. Asset location refers to where you strategically keep the money you're investing – allocating it amongst tax-advantaged, tax-free and taxable accounts in order to maximize after-tax returns. It's not the same as asset allocation, which addresses the type of assets selected in proportion to the overall portfolio. For example, putting high tax investments in tax-deferred or tax-exempt accounts rather than taxable accounts can potentially improve the overall tax efficiency of your investments. Experts suggest up to 0.75% in value can be added annually. We recently employed an asset location strategy and reduced taxable income for a client by over $20,000 annually, resulting in a $4,400 reduction in taxes.

**THE VALUE OF INCOME TAX PLANNING.** A proactive advisor who focuses on your comprehensive needs will consider tax strategies tailored to you

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and potentially generate significant savings. We recently began a relationship with a client who was not aware of tax loss harvesting or Roth conversion strategies. Depending on the size of your portfolio, it can mean thousands to tens of thousands of dollars annually. After some serious conversations about income needs, upcoming required minimum distributions (RMDs), goals for estate planning, analysis of income taxes and Medicare premium brackets and a discussion with the client's CPA, we determined a $150,000 Roth conversion over three years was a valuable strategy for this client. Using a static tax rate we determined that over 10 years this strategy would return approximately $55,000. That amount will grow if tax rates increase and the client lives more than ten years. Additionally, it will increase further if the heirs maintain the Roth for an additional 10 years. This strategy also reduced first year RMD distributions by $6,000, which resulted in $1,320 less taxes. Finally by employing an asset location strategy, it allowed us to accelerate the Roth conversion to two years, down from three.

**THE VALUE OF INSURANCE PLANNING.** In its simplest form optimizing insurance coverage can mean hundreds or thousands of dollars annually. Taking it a step further, eliminating financial catastrophes is priceless! We have a client who held an immediate annuity, suggested by a broker, to cover lost pension income upon the loss of a spouse at some point in the future. In fact, the annuity would not offset future lost income and it was wildly expensive. Working with our team we found an effective solution and reduced the cost by 66%.

**THE VALUE OF DELEGATION.** Time is a finite resource. Financial planning can enhance your and your family's situation monetarily by tens of thousands of dollars annually. Investing in an advisor frees up time and leads to emotional wellbeing. Furthermore, actually completing financial tasks is priceless! Recently we received a call from a gentleman who lost his mother earlier in the year and his father was not doing well. He knew from speaking with his father that probate and income taxes were potentially a problem. We immediately scheduled a meeting. Unfortunately, his father passed away before we could have a discussion, much less rectify any of the issues. While we can't pinpoint the exact costs to this family, we know there were costs in terms of taxes, probate fees and their time. Additionally, was the estate divided the way their father wished? If you are not tackling these important matters, find someone to help you get there before life events eliminate the ability to make strategic decisions.

Our research and more importantly, our actual client experiences support the studies and the value of an advisor. We could share numerous other examples. In short, the results are clear. Methodical analysis, a dispassionate, disciplined process and careful implementation of tailored strategies will lead to value beyond investment returns, all of which are at the core of the advice we provide. When you work with First Merchants Private Wealth Advisors, we provide real, quantifiable value in support of your life goals and peace of mind.

Michael A. Tomaw
Wealth Manager

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## RETIREMENT PLAN

### AS THEY SAY, OUT WITH THE OLD AND IN WITH THE NEW....PLAN DESIGN.

**WHAT'S HAPPENING?** Every six years, the IRS requires all preapproved 401(k) plan documents to restate to newer versions to incorporate law changes, procedural changes and discretionary amendments that have been adopted since the last restatement. The current "Cycle 3" adoption deadline is July 31, 2022. Basically, it's a way of making sure plans don't become antiquated.

Should this be looked upon as a negative? My opinion is no. Prior to these mandatory restatements and after many years of doing so many plan reviews I lost count, I can tell you many plans would look like time capsules from the 1990s without them. They don't modernize themselves.

As plan sponsors start to receive notices from their administration/compliance service providers about the upcoming restatement, there are strategies or concepts worth considering that could significantly improve the success of their retirement plan. In most cases, the sponsor will pay a restatement fee (which typically ranges from $1,000 to $1,500) so making the most of the restatement makes financial sense. Bottom-line: If it has to be done and you have to pay a fee to get it done, you might as well make the most of it.

Some of the primary considerations:

- Have the goals of the plan changed since implementation? Example: Refunds from failed tests have become an annual problem and needs to be addressed.
- Are business owners concerned about the current or future tax environment? Example: *One of the primary benefits of offering a retirement plan is tax benefits. What can be done to lessen the tax burden now or in the future for the company and participants?*
- Is the current design effective and working as well as it could? *Example: It's currently a competitive labor market. Should eligibility rules be made "more welcoming" to new hires?*

FMPWA would appreciate the opportunity to serve you, and we hope this information helps you understand when and why your plan must be restated.

If you have any questions or would like to talk to one of our retirement plan team members, the Retirement Specialists at First Merchants Private Wealth Advisors are here to help:

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*As the adage goes, clients do not care how much you know until they know how much you care. And more than the reward of effective expertise, it is the strength of the relationships we have with our clients that brings us charging through the door each day.*

MICHAEL JOYCE
*President, Private Wealth Advisors*

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