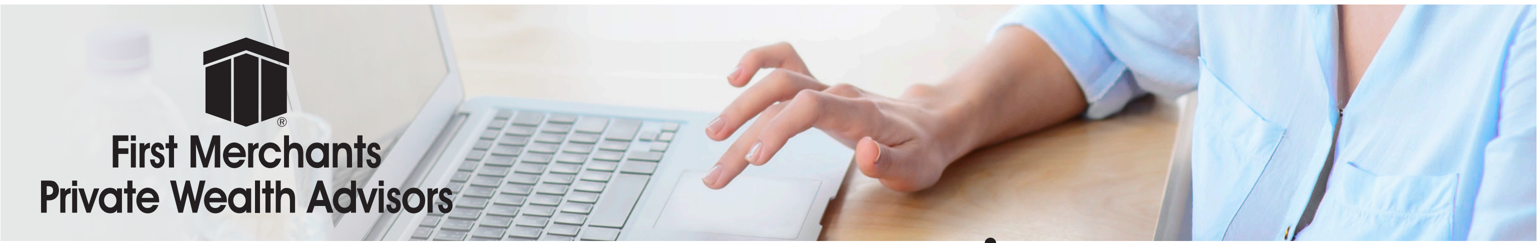

PRIVATE WEALTH *perspectives* VERSION 18.4

The third quarter has marked a return of volatility to the markets. In times of volatility, investors true risk tolerance is tested. The confluence of risk tolerance, available resources and goals is the foundation of any sound financial plan. Our team is actively engaged with clients to ensure that recent market activities have not impacted this confluence. As you have read in recent communications from our team, we view current market actions as healthy and primarily driven by readily identifiable endogenous factors. However, we do not take the latest market actions lightly and are working diligently to ensure our clients are properly positioned to reach their financial goals.

Once again, our team has come up with relevant information for this edition of Private Wealth Perspectives. Thanks for choosing us as your partner.

INVESTMENT MANAGEMENT

Incentives Matter

First day, freshman year of college, Microeconomics 101 class. Two words were written on the white board: Incentives Matter. My professor spent the better part of that first week of class drilling this concept into the minds of a roomful of impressionable 18 year olds. Obviously it worked because it has stuck with me all these years. What I didn't realize then was how much incentives really do matter in so many aspects of both micro and macroeconomics. The concept of incentives matter simply suggests that people respond predictably to positive and negative incentives. Pretty basic, yes, but also quite profound. Incentives are used to manipulate behavior beginning at a very young age. I tell my 6 year old son to clean his room and I hear, "No" or "I don't want to" or "not right now." But if I give him an incentive to clean his room, such as a quarter, or a cookie, or some screen time, suddenly his behavior changes. Economists, policy makers, and business people worldwide understand the power of incentives on human decision making and use them to drive desired outcomes.

Consider the current trade negotiations between the U.S. and China. A tariff, a tax on imports or exports between sovereign nations, is nothing more than an incentive to change consumers' behavior. President Trump's use of tariffs is giving manufacturers an incentive to use U.S. produced goods in place of Chinese produced goods. Let's say a U.S. heavy equipment manufacturer formerly bought Chinese steel at $500 per ton because it was less expensive than U.S. produced steel at $575 per ton. Impose a 25% tariff on Chinese steel, and suddenly the cost of Chinese steel is $625 per ton. You have just given the manufacturer an economic incentive to purchase U.S. steel. The key is that responses to incentives are predictable because people almost always respond in their best interest.

The most famous example of incentives matter in economics is the idea of the demand curve – when something gets more expensive, people buy less of it. This basic economic tenet is the whole reason things go "on sale" since the lower price gives consumers more incentive to buy. Convenience can also be an incentive to buy….just ask Amazon. Opponents sometimes find the idea of incentives hard to accept, especially when it comes to basic necessities. A cynic may say he still buys gasoline, even when the price goes up. He may still buy gasoline when the price goes up, but he will try to find ways to buy less. Maybe he will car pool, take public transportation, ride his bicycle or put off that road trip. If the price of gas stays high long enough, it may even be an incentive to trade that SUV for a Prius or even cause him to move closer to work.

Sports contracts are often laden with incentives in an effort to motivate players to perform. One of the more interesting sports contract incentives in recent memory involved weight goals for NFL running back Eddie Lacy. I'm not talking about how much weight he could lift, but how much he actually weighed. Following a history of weight issues during his time with the Green Bay Packers, Lacy signed with the Seattle Seahawks in 2017. Lacy's contract with the Seahawks called for seven weigh-ins during the season, worth a total of $385,000. He simply had to step on the scale each month and collect a check for $55,000 as long as he weighed less than the amount written in his contract. Incentives can be used for good and they can also lead to poor decisions. Consider the Wells Fargo sales practice scandal where Wells Fargo employees opened accounts in customers' names without their permission in an effort to reach sales targets. Too much of the employees pay was tied to incentives for opening new accounts. Some employees responded poorly, yet predictably, by choosing to do what was in their best interest financially. They got caught and it didn't end well, but their behavior was driven by incentives.

Incentives are also behind the interest rate policy decisions at the Federal Reserve. In an attempt to jump start the economy amid the fallout from the 2007-2008 financial crisis, the Federal Reserve dropped the Fed funds rate to 0% to provide an incentive for individuals, corporations, and small businesses to continue to borrow and lend. It worked. People responded predictably by refinancing their homes at lower rates and buying new cars (remember Cash for Clunkers?). Corporations responded by issuing billions of dollars of new debt at record low rates. The low interest rates had the exact stimulative effect on the economy that policy makers were hoping for. Low interest rates also gave people an incentive to invest in the stock market. Where investors might have been happy to collect 4% on a CD investment prior to the financial crisis, the 0.25% CD rates following the crisis offered little incentive to keep your money in CDs, money market or savings accounts. So people responded predictably by choosing an alternative that was in their best interest…. the stock market. Did 10 years of record low interest rates serve as the fuel for the current decade long bull market run? Intentionally or unintentionally, easy monetary policy most certainly has played a big part in it.

So the question now is, when do higher interest rates eliminate the incentives that are driving economic growth? The Federal Reserve in September issued another ¼ point rate increase, the third of the year and 7th overall since 2017. Two to four more rate increases are expected over the next year. At some point higher rates act as a disincentive and lead to less borrowing, fewer auto purchases, and less home buying. Higher rates will also pull money out of the stock market and back into deposit accounts as rates become more attractive.

I understand why the Fed may feel the need to raise rates, and by as much as they think they can get away with. Because when the next recession comes, they need to have some room to move….enough cushion that they can cut rates and start this whole incentive driven process over again. It's a delicate balancing act because overly aggressive Fed tightening can be the very cause of a recession. As the Fed considers further rate hikes in an effort to find that "neutral rate" or the perfect balance between stimulative and restrictive monetary policy, here's hoping they remember that "Incentives Matter", and people will respond predictably.

PERSONAL TRUST

Charitable Gifts under the 2018 Tax Act

It's November and the final quarter of 2018 is underway. The approach of December 31st signals not just the coming of New Year's Eve but the deadline for charitable contributions for the current year.

The 2018 Tax Act has made some significant changes to the charitable gift landscape that you should be aware of. What has changed? Very simply, the standard deduction for a married couple has been increased from $13,000 to $24,000 for 2018. To deduct charitable gifts you need to be able to itemize your deductions and the increased standard deduction has taken that option away for many of our clients.

What are your options to get the best tax result from your charitable gifts? There are three charitable gift strategies that can still provide some tax benefit even if you will be unable to itemize deductions under the new law.

First is the existing provision that allows you to make charitable distributions directly from your IRA to charity. If you are 70 ½ and required to take minimum annual distributions, you can make a direct transfer to one or more charities from your IRA of up to $100,000 each year. While not a tax deduction, these distributions of what would normally be ordinary income given to charity are not taxable to you creating a tax free IRA withdrawal to make your charitable gifts.

A second strategy that has also been around for a long time is making charitable gifts of appreciated assets. This used to be like double dipping in that you received a tax deduction for the charitable gift of the full value of the asset gifted as well as not recognizing any gain on the transfer to charity. While the direct charitable deduction may have been lost, not paying capital gains taxes is still a benefit and certainly preferable to just writing a check for larger charitable donations.

A final option especially if you are close to hitting the standard deduction is what is being called "bunching". Looking at all of your normal charitable gifts for a given year and doing both this year's gifts and next year's gifts "bunched" in one calendar year. For example making all of your 2018 and 2019 gifts in December of 2018 and then skipping 2019. You of course need to do the math, but if doubling up allows you to deduct this year you can then skip the following year and repeat. A plea from various charities that I work with is that you let them know this is your pledge or gift is for both years so that they can budget accordingly.

It has always been my experience that charitable giving is not primarily driven by a tax deduction. However getting the best result for the charities you support by taking advantage of what the tax code allows is always smart financial planning. Please feel free to let me or any of the team at First Merchants Private Wealth Advisors know if you have any questions or if there is anything we can do to help you pursue a secure and rewarding financial future.

RETIREMENT PLAN

Utilizing Your HSA Plan

Discrimination testing is part of most of our lives if we participate in a non-Safe Harbor retirement plan. Discrimination testing (also known as ADP/ACP testing) is performed each year on plans with 401(k)/Roth employee contributions and on the matching contributions (again, unless the plan has a Safe Harbor Contribution that clears the annual testing measurements).

When a test does not pass the regulatory requirements one of two correction methods must happen. The Employer can make further contributions to the Non-Highly Compensated Employees (NHCE) to increase their percentages in order to pass the test. The other correction method and one that is most popular is to refund the Highly Compensated Employees (HCE) a portion of their contributions to the plan in order to bring the disparity between the two groups in line with federal regulations.

If you have experienced a testing refund in the past your first reaction may be to reduce the amount of contributions you are making to your plan. Refunds are not RED flags for the IRS, so receiving one back shouldn't be a worry to you. So my suggestion would be to keep contributing to be sure each year you are getting the most dollars into the plan allowed by law.

If you haven't already fully funded your HSA contribution for the current or prior year and you receive a refund due to failed testing, consider fully funding your HSA. HSA's are a tax deductible way for you to save for those unexpected medical occurrences if you are in a High Deductible Health Insurance Plan. Like with any tax deductible investment vehicle there are limits to the amount you can fund. For 2018 they are as follows:

HSA Individual - $3,450

HSA Family - $6,900

HSA Catch up - $1,000

This strategy can also help if you have hit your annual contribution amounts to a plan for your employee contributions (for 2018 deferral limits: $18,500 and for the 50 and older contributor $24,500).

Should you have questions regarding a testing refund and the use of an HSA as a place to "park" that refund, or if you would like to talk about opening an HSA with us, do not hesitate to call one of our Retirement Plan team members here at First Merchants Private Wealth Advisors.

PRIVATE BANKING

Easy Button

I recently had the opportunity to recall and relate to a well branded marketing campaign – the "Easy Button". Introduced by a national big box retailer to businesses and consumers, the strategy was to offer easy and straightforward solutions that may seemingly be difficult without their services. The Easy Button caught fire and big, red Easy Buttons were soon popping up in homes and offices across America, seeking a tongue-in-cheek outlet to address daily frustrations to get the job done.

This recollection came to me during a recent luncheon held with a well-established business owner and potential private banking client. Over the course of many years, she successfully built her company to a level that gained some attraction by outside suitors and eventually executed the sale of her business. In nearly an instant, her personal balance sheet transformed from a valuable business asset to an equally valuable liquid asset. Additionally, she found herself still very interested and inclined to pursue other business ventures which are neither yet identified nor defined. Taking into consideration her personal balance sheet and objectives to nimbly be prepared to make future investments, I was able to offer some solutions to appropriately maximize both. Her response, stated somewhere between being a statement and a question was, "Well, that doesn't sound very hard to do. (?)"

Her comment was both interesting and compelling. Building personal wealth – as an entrepreneur, family business, professional or executive – has many ingredients unique to each situation. What is not unique to the recipe, however, is time and hard work. Easy Button not included. For well qualified individuals, Private Banking takes into account each hard earned personal balance sheet and success and offers streamlined solutions unique to each client. Unlike our big box counterparts, solutions are not a ready-made product off the shelf. Rather, solutions are customized and are exclusive to our Private Banking clients. Our experienced team of 6 Private Bankers look forward to serving you and, as always, greatly appreciates your business and relationship.