Private Wealth *perspectives*

VERSION 22.3

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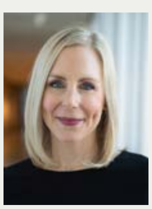
And so concludes another quarter of volatility in a year marked by volatility. A steady hand is required to navigate turbulent waters and we appreciate the trust you have placed in our team during these most interesting of times. Please take some time to benefit from our perspective in the included articles and thanks again for your partnership.

Michael Joyce
President, Private Wealth Advisors

WEALTH MANAGEMENT

> *"The best time to plant a tree was 20 years ago. The second-best time to plant a tree is now.*
>
> CHINESE PROVERB




Helping You Prosper – The Importance of Succession Planning for Business Owners

Are you or a family member a business owner? If so, think about the beginning. Perhaps these are recent memories? Or was your business started by a family member whose legacy you are carrying into the future? No matter when your business was born, it is often started because of someone's great idea or passion. Owning a business can be exciting and exhausting all at the same time. As an owner your attention is often drawn in many directions. Sales, customer service, growth, employee matters, administration and competition are just some of the demands you face regularly. But how often do you stop to think about what happens after you no longer wish to be involved in the business? Who will take over? What happens if "something happens" to you? If you wish to place your business in the hands of the next generation, how will you extract the value you've created to fund your retirement or next venture?

Succession Planning can be complex and specialized to each individual situation. It involves areas of financial planning which include funding the transition and tax strategies, liquidity reinvestment plans, whether for retirement or funding another venture, and estate planning. Because the demands of running your business are constant and of course a high priority, succession and by extension, contingency planning often takes a back seat to more immediate concerns. At First Merchants Private Wealth Advisors, we can help ease the overwhelming feeling planning for your future can create. In this article you will read about what you can be doing now to prepare for the future and how our team can provide valuable experience-based guidance to help you avoid unintended consequences.

First, here are some statistics to stage the importance of succession planning. Did you know **90% of all US family businesses are run by family** and many of these business owners want and often expect their children to take over the business? But **only one third of these businesses survive until the second generation!** Even fewer end up in the hands of the third generation, just 10-15%, and a mere 3% move to the fourth generation.

Why is this the case? What is causing this phenomenon? Some research points to a disconnect between the parents/owners of the family business and what their children envision. Each generation comes with their own set of values. It is important to understand where each is coming from and their priorities when crafting a succession plan. The demands of running a business may conflict with the next generation's values, where as an example, work/life balance may be a higher priority. Understanding differences in generational values and priorities along with early and straightforward discussions go a long way to ensure disconnects are uncovered and addressed.

Another reason which often surfaces is that starting and building a business is the exciting part! As stated earlier, a new business is often borne from a great idea or a person's passion. Once past the early stages, the next generation may not share the same level of enthusiasm. After all, starting and growing your own business is different than taking responsibility for one that is already in operation and started from someone else's idea or passion. It's not to say one phase is better than another but rather, needs and demands change as the business matures.

Sometimes differences can be surmountable, for example views on hiring or business investment. Others are crucially significant, such as a general lack of interest in taking on the business. In all cases, clear and direct communication is imperative. Each family member involved or expected to be involved should openly share their priorities and all should be clear on how it will impact the prosperity and continuity of the business. Equally important is sharing expectations and taking the time to formalize plans and agreements to avoid unintended consequences, particularly when the unexpected happens.

Over the years, our team at First Merchants Private Wealth Advisors has witnessed examples of how generational priorities combined with a lack of planning can adversely affect families and their businesses. Let's examine one such example. There was a client whose family owned a rather large and successful business. The patriarch passed away suddenly and was survived by his two biological children who were in management positions within the business, along with his wife, the children's stepmother. Over the years, the owner and family patriarch lent large sums of money to the business. These loans were never documented, just understood, or thought to be understood between the parties. After he passed away, the stepmother believed the loan payments were due and owed to her. The children disagreed. The relationship between the children and stepmother became strained and since the loan was never formalized, each believed their view to be correct. Without going into further detail, situations such as this one can fracture familial relationships and lead to legal battles, potentially causing harm to the business as well. A simple loan document, formalizing the arrangement could have easily solved their issues.

In another situation, a client who was part of a third-generation family business decided to retire and wished to redeem his shares in the business. While there was a succession plan in place, the lack of a formal valuation and liquidity plan created issues. Lack of liquidity can pose a threat to the execution of a succession plan. Understanding and preparing for how transitions take place are just as important.

Lastly as an owner, most of your financial resources are likely invested in a single asset – your business. As you transition, it is important that your succession plan consider tax implications to you and your business, your future income and liquidity needs along with estate planning. A successful succession plan prioritizes these areas along with the other aspects of your plan. In short, succession planning involves planning beyond the transfer of ownership. Income replacement, wealth preservation, wealth transfer and tax mitigation move to center stage following your transition.

When considering who to involve in building your succession plan, we urge you to surround yourself with a team of experts. Your team should work collaboratively and include your accountant, attorney, key employees, business valuation professionals and experts from our First Merchants Private Wealth Advisors team along with our team of First Merchants bankers. Each offers expertise in areas which relate but are not duplicated by the others, all of which are crucial to ensuring your succession plan produces the outcome you and your family desire!

Audrey Mistor, Managing Director, Wealth Management	Anna Little, Wealth Manager

INVESTMENT MANAGEMENT

> *There are decades where nothing happens; and there are weeks where decades happen.*
>
> VLADIMIR ILYICH LENIN

SLAYING THE INFLATION DRAGON

Let's start with the obvious: the Federal Reserve is pressing the brakes. Hard. Economic growth is now cooling as intended, and equity market valuations are adjusting lower in response to higher interest rates. Underlying the tumultuous market volatility and daily headlines is the fact that breaking the back of inflation is a necessity for a healthy long-term investment outlook. Sustained high inflation has historically weighed heavily on asset valuations, as shown in the chart below, as interest rates are pushed higher, and investors require greater rates of return in the equity markets as well. The greater risk to the economy and financial markets is in doing too little and allowing sustained high inflation to fester and feed on itself. The Federal Reserve recognizes this and is determined to maintain credibility in its ability to restore price stability.

Source: Bloomberg. Reflects monthly values dating back to 1/31/1954.

With that context, Jerome Powell didn't pull any punches in his August 2022 Jackson Hole Symposium remarks. The Fed chairman talked about using the Fed's tools forcefully. He also mentioned that a sustained period of lower growth and a softening labor market would likely be required to resolve the inflation problem. Lastly, the Fed Chair delivered a powerful statement confirming that the central bank would "keep at it until the job is done," even if this brings some short-term pain to households and businesses. The stock market reacted, retracing some of the ground it had made up over the last few months since mid-June, as Powell's direct comments diminished hopes for a soft-landing.

Following the pushback from Powell and other Federal Reserve members against the potential for a near-term policy pivot, rate hike expectations have reset to reflect the prospect of higher interest rates for longer. Fed funds futures now point to short-term rates hitting 3.75% to 4.0% by year end and remaining there until late 2023/early 2024 before easing lower. Treasury yields have lifted higher with the two-year Treasury yield at its highest point since 2007 at over 3.4%, and the curve is firmly inverted, indicating higher potential for an economic downturn. Based on the yield curve, the Federal Reserve Bank of Cleveland pegs the probability of recession over the next 12 months at 27% as of the end of August, and this may continue to tick higher as the Fed pushes up short-term rates.

When the talk of recession is on the rise, so too is the temptation among investors to stray from their long-term investment strategies and try to time the market – this is where the greatest investment mistakes are often made. The stock market is a forward discounting machine that will sniff out the top and the bottom in corporate earnings long before they occur. In fact, according to a study by Robert Schiller and Goldman Sachs, in U.S. bear markets dating back to 1903, the stock market has bottomed 6 to 9 months before earnings per share started to rise on average.

We would also note that while the prospects of economic growth are receding and that will have implications for corporate earnings, the stock market is not the economy. At the end of the second quarter, real GDP was up 2.5% compared to before the pandemic at the end of 2019. During the same period, the S&P 500 earnings per share were up 36%, according to FactSet. Despite recent downward revisions, forward looking, bottom-up earnings forecasts for the S&P 500 are expected to grow by 8.3% in 2023.

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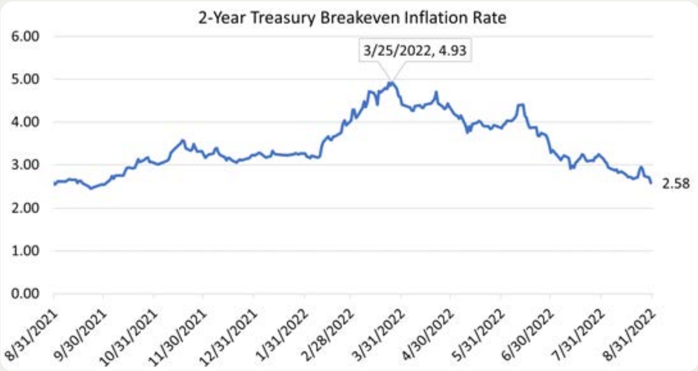
Although the near-term market picture is likely to remain volatile given the uncertainty of the extent to which conditions will be tightened, financial markets reflect the belief that the Federal Reserve will be successful in its mission to restore price stability. U.S. Treasuries began discounting improving inflation metrics several months ago with yields now reflecting annual inflation of 2.58% over the next two years compared to 4.93% back at the peak in March.



Source: Bloomberg

At First Merchants Private Wealth Advisors we strive to focus less on the timing of the next recession and more on the long-term value of selecting investments in high quality, self-sustaining companies and institutions with strong balance sheets and robust cash flows that can withstand the ebb and flow of economic cycles on behalf our clients. In many cases, these businesses emerge even more valuable from economic dislocations as they can take market share from competitors playing defense and purchase assets selling at discounts from those needing liquidity. Similarly, we look to take advantage of market dislocations to buy strong businesses selling at discounts to their intrinsic value and then allow those investments to compound for the long-term. As always, we are here to help navigate the risks and opportunities of these uncertain times. Please don't hesitate to reach out to your advisor with any questions or concerns.

David Pfeiffer
AVP, Associate Portfolio Manager
& Investment Analyst

RETIREMENT PLAN SERVICES

Are you monitoring your retirement savings progress?

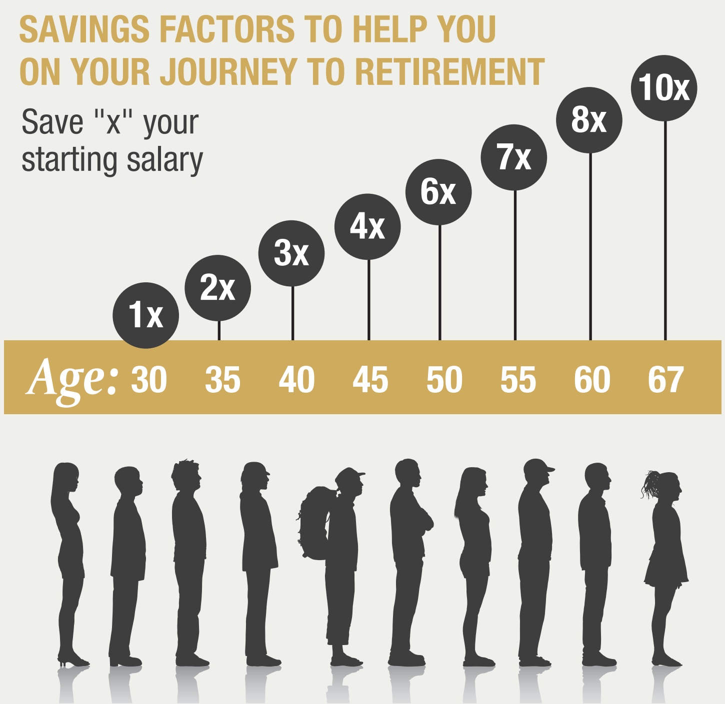
As a runner, and I use the term "runner" loosely when describing myself, I'm always measuring my progress. Whether it's a training run or actual race, I'm monitoring my pace throughout. This lets me know if I'm ahead or behind my desired finish time. Do I need to push harder, or am I able to conserve energy for later? I've yet to find a dishonest stopwatch. This concept should be applied to saving for retirement, which is a multi-decade journey for most of us. While collecting information on this topic, I discovered some of my old "rule of thumb" assumptions had become, well… old.

For years, I had been quoting retirement savings targets as:

- Age 30 should have 0.5x current income saved.
- Age 35 = 1x, 40 = 2x, 45 = 3x, 50 = 4x, 55 = 5x, 60 = 6x, 65 = 7x

Currently, Fidelity Investments is saying:

- Age 30 should have 1x current income saved.
- Age 35 = 2x, 40 = 3x, 45 = 4x, 50 = 6x, 55 = 7x, 60 = 8x, 67 = 10x



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Hard to know exactly when my old assumptions became antiquated and my apologies to the 50-year-old who has 4x income saved and is now being told it should be 6x income. Earning $80,000 means that $320,000 nest egg now should be $480,000. That's quite a jump. In reality, the 50-year-old with $320,000 will likely be fine but it's still good to know they should probably aim higher. The rub here is most 50-year-olds don't have near that saved. According to a 2020 report from Vanguard, the average 401(k) balance for ages 45-54 is $135,777. That balance would be the goal for a 50-year-old earning $22,630 a year. What's worse, the median saver in that age bracket only has $46,363. We've heard Americans are behind in their savings and here's the proof. What can be done? Is it too late? Not exactly. Here's an encouraging illustration:

- Initial Age: 50
- Initial investment: $46,363
- Monthly contribution: $1,000 (could include an employer contribution)
- Length of time: 17 years (to age 67)
- Estimated interest rate: 8.5%
- Interest rate variance: 1.0%
- Ending balance: $609,405.68 (8.5%), $681,438 (9.5%), $545,627 (7.5%)

Those ending balances may or may not equate to 10x income at age 67, but this looks encouraging and doable. In this case, the 17-year timeframe still delivered a respectable balance through periodic investing and compounding. The key takeaways here are 1.) Monitoring your progress and adjusting accordingly are keys to building a sufficient nest egg and 2.) Don't get discouraged by thinking it's too late; it may not be. A rather sizeable participation medal could be waiting for you at the finish line!

Kris Feldmeyer
Retirement Plan Advisor

2022

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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