

Independent *thinking*

Building a sustainable portfolio

Jonathan Knee on media moguls

China and U.S. monetary easing

Equities, interest rates, TIPS

AlphaShares on investing in China

The *Stability* Issue

Building a Sustainable Investment Portfolio

Form ever follows function. When he coined the since abbreviated phrase in 1896, Louis Sullivan was speaking about architecture, specifically about Chicago skyscrapers. But investment portfolios similarly should be designed for their intended purpose, to accommodate the needs and aspirations of the individual, family or related institution – and to stand the test of time.

Unfortunately, most financial advisors follow a fixed path, one that Sullivan might have likened to the “form follows precedent” approach of his own predecessors. In a nutshell, this investment sequence typically goes something like this: a high-level review of the client’s general goals; a mean-variance optimization analysis to determine asset allocation; asset classes defined by security type (cash, bonds, stocks, alternatives); and the selection of asset managers for each asset class. Implicit in this sequence is that liquidity will be available at stated intervals and that the managers’ performance will be judged on a relative basis.

And then the wind changes. The market events of the past two years and those of 2000-2002 have illuminated the structural flaws of traditional investment plans. The objective should be to develop investment plans for clients that are sustainable across a spectrum of events and not simply at one fixed point in time.

Let’s look at today’s investment climate from the perspective of a married executive who retired in 2000 at age 55 after a lucrative career as a lawyer in Silicon Valley. We’ll call him Christopher, which is nothing like his real name but does speak to the excitement he felt on retirement at the prospect of exploring new worlds and opportunities. At his relatively young age, he was confident that time was on his side, both in terms of building an appreciation-oriented portfolio and finding rewarding opportunities to further fund his lifestyle and his long-term family and philanthropic goals.

After 10 years of little equity appreciation and, more recently, declines in the market value of other *(continued on page 3)*

A message from the CEO

2011

promises to be another eventful year in the investing world and we at Evercore Wealth Management are looking forward to it. We have been very fortunate in the two years since our inception and are grateful for the support and engagement of our clients as we continue to grow.

In our inaugural issue of Independent Thinking, we discussed the concept of goals-based investing. Here we focus on the pitfalls for investors in traditional, more proscriptive plans; the next issue will take an in-depth look at implementation of our approach. Clearly, we have a lot to say on this score, as goals-based investing is one of the key strengths of our firm. It serves the interests of our clients, helping individuals and families focus on the big picture and face the future with confidence.

Now is, and will always be, the most difficult time to invest. But we see exciting opportunities in 2011 and further out, as well as challenges. Here, John Apruzzese takes a cool look at the hottest subject in investment circles; the Fed's latest round of quantitative easing, or QE2. Our view on both the drivers and the likely consequences is less extreme than most in the market, as we suspect that fears of rapid inflation and dollar debasement are overblown.

We also hear from two best-selling authors who are also well-known professors and investors in their own right. Jonathan Knee, a colleague at Evercore Partners and a leading authority on the media business, is skeptical about the role of moguls in the industry, arguing that their high-profile and headline-

grabbing deals may come at their investors' expense. And Burton Malkiel, one of our external managers, discusses the investment outlook for China and his firm's broad-based all capitalization index exchange traded fund. At Evercore



Jeffrey Maurer
Partner and CEO

Wealth Management, we see enormous – and continuing – opportunity in China and are pleased to offer this fund as appropriate to investors seeking targeted exposure to the emerging Chinese consumer class.

Finally, we expand here on some of our core capabilities. Tim Evnin and Judy McDonald Moses take a fresh look at blue chips; Gary Gildersleeve and Brian Pollak weigh in on, respectively, bonds and Treasury Inflation Protected Securities.

As always, please feel free to contact any of the partners at Evercore Wealth Management for further information and with any questions or comments you may have. We have received a very positive response to our last issue of Independent Thinking and welcome all continued feedback.

On behalf of all of us at Evercore Wealth Management, we hope that you and your family had a very happy holiday season and wish you peace and prosperity throughout the New Year.

A handwritten signature in black ink that reads "Jeff".

Jeff Maurer
Chief Executive Officer

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COVER STORY: Building a Sustainable Investment Portfolio

(continued from page 1) asset classes, apart from investment grade fixed income, Chris, now 65, realizes that the time horizon of his portfolio has contracted. At the same time, the board positions and consulting roles that he had expected to be offered have dried up, the residue of the weakening economy. Most of his contemporaries have also left work, some considerably earlier than they had planned.

Chris now has an increased need for current income in a consistently lower-yielding environment to support a retirement plan initiated at the high of the technology bubble.

But his portfolio wasn't designed to accommodate market deterioration or extreme volatility. Reinvested proceeds from bond maturities are generating lower yields and assets viewed as bond substitutes have either declined substantially in value or have extended liquidity restrictions. Absolute return vehicles, which accounted for a sizable proportion of his portfolio, aren't pulling their weight either. Typically sold through fund-of-funds strategies, these are focused solely on pre-tax returns. However, as more monies flowed to these strategies, the layers of fees and higher taxability of most absolute return vehicles caused after-tax, net of fee returns to trail much more conservative and liquid asset classes such as investment-grade bonds.

Liquidity too has become an issue. In the early years of the decade, Chris participated in a variety of alternative investment products, including hedge funds, and funds that invest in real estate and private equity. As these investments performed reasonably well, he became more comfortable with allocating assets to vehicles that had liquidity restrictions ranging from either 10-year lock-ups to quarterly or annual liquidity terms. But the credit crisis burst the asset bubble in real estate and he discovered to his dismay the inherent tail risk in many other

alternative asset classes, concentrations in which now needed to be managed.

At Evercore Wealth Management, we met Chris when he came to us in search of an alternative plan, one that better reflects his goals and circumstances but accommodates his existing holdings. We've been able to resuscitate his enthusiasm for the future by defining, for the first time, his true goals and risk tolerance and investing accordingly, with individual asset pools established to fund – and defend – specific goals by importance and by purpose across our five asset classes: cash; defensive; growth; diversified market hedges; and illiquid growth and special situation assets (the last are allocated to growth assets and specific opportunities that may assume illiquidity to achieve a premium return and/or a low correlation to liquid growth assets). Grouping asset classes by purpose allows us to address the client's actual goals and objectives while protecting the portfolio as a whole.

In other words, the form of Chris' portfolio now follows its intended function. So too does our review process and performance measurement, which is calculated not only in relation to the relevant indices, but also in light of our success in meeting his goals.

For all investors, the effective time horizon may be shorter than it first appears. The goal of providing current cash flow and a minimal level of liquidity should not be thought of as a single 35-year goal but instead as a series of one-year goals that need to be sustained and buttressed over 35 years. Similarly, assets used to meet multiple objectives may not be effective. For example, a so-called bond substitute that is held in an illiquid structure may help to mitigate investment risk but the lack of liquidity at any one point in time may jeopardize the plan as a whole.

Event risk and its corresponding outcomes (lack of liquidity, lowered safe

asset yields, real estate price declines, and reduced self-employment income) should be factored into any investment plan. For a 55-year-old approaching retirement, the risk of relatively illiquid investments can clearly compromise the sustainability of the plan as a whole. As the events of recent years have taught us, nearly all investors need cushions to withstand extreme volatility, no matter how improbable the events. We have, after all, experienced two statistically impossible events in the U.S. markets in just 10 years. If we live on fault lines, we should build accordingly.

Editor's note: *The next issue of Independent Thinking will examine portfolio construction and asset allocation in the context of goals-based investing.*



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Investors Get The Moguls They Deserve

by
**JONATHAN A.
KNEE**

*Jonathan A. Knee is a Senior Managing Director at Evercore Partners and runs the media program at Columbia Business School. He is the author of **The Accidental Investment Banker: Inside the Decade That Transformed Wall Street** and, more recently, **The Curse of The Mogul: What's Wrong With The World's Leading Media Companies**.*

A little over a year ago, I co-authored a controversial book titled *The Curse of the Mogul: What's Wrong with the World's Leading Media Companies*. In it, we argued that investors had for far too long accepted systematic underperformance from the largest media companies. As evidence for this proposition, we pointed to the remarkable track record over a generation – both before and since the emergence of the Internet as a disruptive force in the industry – of media stocks dramatically lagging the overall market indices. We also noted that in the last decade, just three of these companies collectively managed to write down over \$200 billion in assets from their balance sheets. The magnitude of this value destruction, while significantly exceeding, say, the size of the entire government automotive bailout, has somehow escaped much public attention.

What made *Curse* controversial, however, was not focusing attention on this admittedly startling data. After all, information on stock price performance

and balance sheet write downs is widely available to anyone who takes the trouble to look. The real source of contention has been our view that the conventional wisdom of the media industry, which continues to underpin many of these companies' strategies and its appeal to investors, is itself the cause of the disastrous results. Unless something changes quite fundamentally in their approach to the business, media investors are likely to suffer the same fate in the future that they have in the past – if not more so.

For years, media moguls have declared their fanatical allegiance to pursuing growth, going global, crowning content as king and embracing the Internet. There is no better argument against these four misguided tenets of media management than the results of the sector over the past year. With a modest economic recovery and resulting rebound in advertising, the media industry slightly outperformed the market overall. One company, however, significantly outperformed every other major name in the sector this year, almost by a factor of two. And that company, Time Warner Cable, has publicly eschewed every aspect of the media conventional wisdom that the underperformers embrace.

Growth, like anything that is not free, is only “good” if it is obtained at a reasonable price. The predominant source of growth in media has been acquisitions that simply have not paid for themselves, as the particulars of the \$200 billion in write downs attest. Time Warner Cable has invested in growth both internally and through acquisitions, but only where the return exceeds the cost of capital. The company has told investors that it has no intention of expanding into international markets where it has no experience or advantage or acquiring expensive content assets that rely on hits and high-priced talent. While Time Warner Cable has a highly profitable Internet-based, high-speed data product, it has not blindly sought to embrace the Internet as

an alternative channel through which to receive its core video product.

The success of media executives at convincing investors of the virtue of their conventional wisdom in the face of demonstrably inferior performance not just



Jonathan A. Knee
*Senior Managing Director
Evercore Partners*

this year but for decades is a testament to their persuasiveness. The implicit mogul argument may be that the sector's reliance on creative talent both requires unconventional management methods and makes them personally indispensable. It

*“Growth, like anything
that is not free,
is only good if it is
obtained at a reasonable price.”*

is perhaps not a coincidence that the CEO of Time Warner Cable, Glenn Britt, is the least well known outside industry circles. Investors get the moguls they deserve and Time Warner Cable's success suggests that they should seek out a fresh quality: anonymity.

The Curse of the Mogul: What's Wrong With the World's Leading Media Companies will be published in paperback by Portfolio in February.

Lost in Translation: China and the Outlook for QE2

by JOHN APRUZZESE



Plans by the Federal Reserve to print money for the second time in eight months, known as quantitative easing or QE2, have generated a firestorm of criticism, with investors just about everywhere predicting the debasement of the dollar and rapid inflation. To see where this path will take us, we need to look first to China which is effectively forcing the Fed's hand.

China has been buying U.S. Treasuries and printing new currency for years. After pumping over \$1 trillion new yuan into its banking system over five years while running a \$250 billion average annual trade surplus with the United States, China's banks have reacted as we would expect, by leveraging the additional reserves by many multiples in the form of new loans. As a result, bank loans have grown at between 20% and 35% per year over the last four years.

Today, total bank loans outstanding in China total \$7 trillion, more than in the United States which has an economy three times its size, at least in official exchange rate terms. As the chart below illustrates, China's money supply is also greater than that of the United States. In other words, there is a shockingly large amount of money sloshing around in China. Consequently, measured inflation is running at 4.4% and rising, with food inflation over ten percent. And, as indicated by the recent rapid price inflation of just about all global commodities, the real figures may be significantly higher.

China is now slamming on the monetary brakes. Once the largest buyer of U.S. Treasuries with \$1 trillion of the total \$9 trillion of outstanding debt, the country changed direction about 18 months ago and stopped buying. In this light, the U.S. government had little choice but to launch QE2 to fill the void caused by China's exit. (As announced

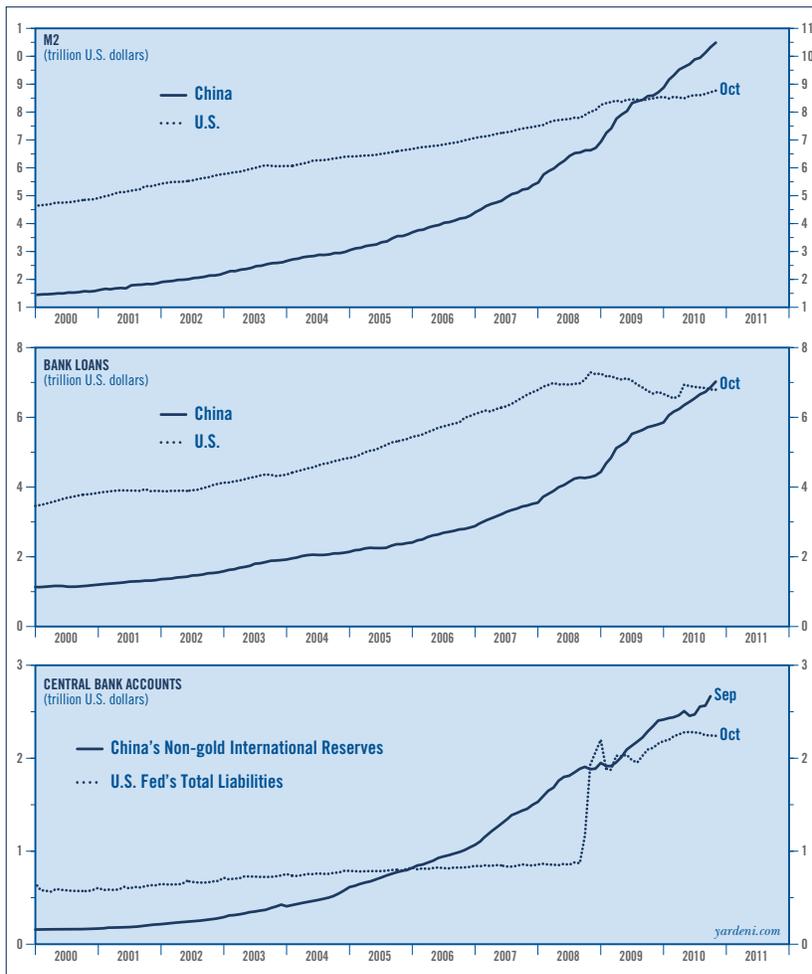
on November 3, the Fed plans to buy up to \$600 billion of Treasury bonds in eight months at \$75 billion a month. That's on top of its previous commitment to buy about \$25 billion of Treasuries a month, bringing the total spend to \$100 billion a month, or approximately the same amount that the U.S. Treasury plans to borrow over the same period to fund the \$1.2 trillion deficit.) Additionally, China has since started to sell its \$250 billion a year in incoming U.S. trade dollars and instead has accumulated euro, yen, South Korean won and gold.

Of course, China would find it easier to stop printing excessive amounts of yuan if

it let the currency appreciate against the dollar. Otherwise, continued high inflation in China will cause the country's relative labor and production costs to increase, effectively generating the same result as an appreciating currency without the advantage of additional purchasing power for the imported natural resources. To date, however, the Chinese government has only been willing to let the yuan appreciate at a very slow rate.

In the United States, it looks like the hysteria around QE2 may be overblown, at least in light of related experiences in China and other countries. The two main associated risks *(continued on next page)*

China vs. U.S. Monetary Indicators



Source: Board of Governors of the Federal Reserve and People's Bank of China



– that QE2 will lead to a rapid increase in money supply which will in turn lead to rapid inflation, and that it will generate a long-term reduction in the confidence in the U.S. dollar – recede a bit when considered in a broader context.

Most U.S. banks, still hung-over from the mortgage bubble, have not increased lending as would usually be expected when the central bank floods the system with reserves such as in China. QE2 may be necessary but it will not generate jobs and as such it is not the solution to the main problem facing the U.S. economy. Forty-five percent of all private sector jobs in the United States are at small businesses (fewer than 50 employees) and these businesses were responsible for about 70% of all the jobs created in the last expansion. Generally, small businesses are not worried about credit; they are not hiring because of deep uncertainty and the added costs of hiring caused by the new health care and financial regulation laws, the lack of agreement on future tax rates, and the absence of a visible political solution to the unsustainable fiscal deficits. QE2 does nothing to help here except to intensify that sense of uncertainty.

In addition to the United States and China, Japan has been experimenting with quantitative easing and it is now all but certain that the European Central Bank will soon print large amounts of euro to fund the Irish bank bailout and stave off other crises in Portugal, Spain and Italy. All major currencies are continuing to depreciate against gold, the only form of money that cannot be conjured out of thin air. Until the Fed and other central banks start to show some control over their printing presses, gold will have much further to run.

At Evercore Wealth Management, we believe a well-constructed portfolio includes investments that are a hedge against debasement of the major world currencies. These investments include: gold; debt denominated in the currencies of countries with strong economic growth and stable government finances; U.S. debt instruments with variable interest rates and well-financed, asset-rich companies with pricing power.

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Core Capabilities

Equities:

Hidden in Plain Sight

by **TIM EVNIN** AND
JUDY MCDONALD MOSES

EQUITY MARKET VALUATION

Are equities overvalued? Undervalued? Or fairly valued? That answer depends both on their absolute value and on their value

relative to other investment opportunities. As active, as opposed to passive, benchmark-hugging investors, we focus on individual companies and their role in our clients' portfolios. But we also consider market valuations as a whole.

The price-to-earnings ratio, or P/E ratio, is a good starting point. Comparing a company's P/E ratio relative to its own historic average, its industry and sector, and to the general market, gives us data points that enable us to begin to ask the right questions. We can also use P/E ratios to compare company valuations by market

capitalization, by size and by geography.

On these fronts, the largest companies at present in the S&P 500 appear to be the least expensive, both relative to their own past trading histories and to other equities. The top 50 companies in the market trade at an average P/E ratio of 12.5 times 2011 earnings estimates compared to an average multiple of about 17 over the past 20 years. Relative to smaller companies, as defined by the bottom 2000, which trade on average at 14.5 times earnings, the larger companies are also at an above- average discount.

U.S. Equity Risk Premium (Earnings Yield minus 10-Year Treasury Yield)



While the P/E ratio is helpful in comparing value among equities, we need a different metric to judge relative valuation among different asset classes, in the context of an individual client's goals. One useful comparison is to evaluate equities relative to Treasury bonds. To do this, we can use the earnings yield, which is essentially the inverse of the P/E ratio. We can compare the company earnings yield to a bond yield and calculate their relative appeal; the difference between the two is the risk premium.

For equities, the risk premium reflects the additional compensation for the term (or holding period) due to the uncertainty of outcomes, the higher price volatility, the lack of legally mandated cash flows dedicated to the equity holder, and the position in a company's capital structure (usually the lowest). Given that there are more potential risks to the equity holder, the risk premium should be higher than that of other asset classes, such as bonds, that have fewer or more determinable risks.

Currently, the earnings yield of the S&P 500 is 6.5%; for the largest 50 companies it is 8%. If we compare this to the yield on a 10-year Treasury which is 2.9%, the difference is 3.6%. As indicated by the chart above, this premium is at a multi-decade high, which makes equities at present very attractive indeed when compared with bonds.

As many of these large companies have substantial net cash on their balance

sheets, they are more attractive still. If this cash were subtracted from their equity valuations, it would render their earnings yields even higher.

Microsoft provides an interesting case study to which we can apply this risk premium analysis for judging the merit of an investment in MSFT equity versus debt. On October 1, 2010, Microsoft issued \$1.75 billion of 5-year, AAA-rated bonds with a coupon rate of 1.625%, a mere 40 basis points over the 5-year Treasury bond. On that same date, Microsoft stock closed at \$24.38. Microsoft earned \$2.10 per share in its fiscal year 2010, giving the company an earnings yield of 8.5% and a P/E ratio of 11.8. While some risk premium is appropriate given the relative uncertainty of equities to bonds, the risk premium here of 6.9% above the company's bond yield of 1.625% seems extreme. Also, Microsoft stock pays a 2.6% dividend yield, which is higher than its bond yield even before the tax differential for individual investors. We would argue that Microsoft equity is attractive in both absolute terms and, especially, in relation to its bonds.

At present, there are a number of U.S.-domiciled, large capitalization companies that have similar valuations to Microsoft and that we consider good investment opportunities on both an absolute and relative basis. In addition to being attractive on these simple valuation metrics, these businesses offer additional attractive exposures, notably to fast-

growing developing markets. This provides a natural hedge against a possible U.S. dollar weakness (see John Apruzzese's article on page 5). As a significant portion of their costs are dollar-denominated, these companies become more competitive if the dollar weakens. Also, when earnings from foreign operations are translated back to dollars for reporting purposes, the companies incur an additional dollar earnings benefit.

At the same time, these companies have significant financial flexibility given their high free cash flow generation and often substantial existing cash balances. This gives them the ability to innovate, expand into new markets, make acquisitions, and pay and/or raise dividends.

At Evercore Wealth Management, we think of these companies – those we perceived as the best positioned and the best financed – almost as inflation-protected bonds with an equity kicker. In other words, their stock offers a potential inflation hedge as they raise their payouts to shareholders over a long period of time and a considerable upside from growing earnings and potentially higher valuations.

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Fixed Income:

by **GARY GILDERSLEEVE**

The outlook for interest rates in 2011 is particularly uncertain. President Obama's compromise to extend the Bush tax cuts and lower the payroll tax should enhance the prospects for growth in 2011 and 2012, but also will lead to a higher Federal budget deficit. *(continued on next page)*

Core Capabilities *(continued)*

Thus far there has been a quick adjustment to interest rates across the maturity spectrum.

Several forces may act to mitigate a further rise in rates in 2011 – or even cause their descent. Most difficult to gauge is the ultimate impact of the second phase of the Federal Reserve's quantitative easing program, or QE2. However, the resulting direction of the dollar, the duration of any flight to quality caused by the euro zone crisis or other exogenous events, such as developments in the Korean peninsula, and the outlook for job growth and further fiscal policy moves with the leadership change in the House are all questions that, when answered, could materially effect interest rates. The recent proposal by The National Commission on Fiscal Responsibility and Reform to make all future municipal issues taxable only adds to the factors which could cause tax exempt interest rates to fluctuate in 2011.

Short-term interest rates, as measured by the Federal Funds rate, are likely to remain low throughout the first half of 2011, if not for the entire year, barring any meaningful gains in employment. The average money market fund yield – taxable and tax exempt

Treasuries only increases the potential for short maturity tax exempt yields to remain low.

The historically steep tax exempt yield curve beyond five years reflects the great uncertainty for the immediate direction of interest rates for longer maturities. Domestic inflation assumptions are currently low, but the general consensus is that inflation will reappear. The elephant in the markets is the ultimate effect of QE2, as John Apruzzese discusses on page 5. This was brought to the forefront by the unexpected rise in interest rates subsequent to the Federal Reserve's November 3 announcement of QE2's size and make-up. Should the Federal Reserve proceed with its planned purchases of \$600 billion, primarily focused in U.S. Treasuries maturing within 10 years, those purchases and the reinvestment of principal and income of current holdings will consume all new U.S. Treasury supply through mid-year, offsetting factors which could drive interest rates higher. However, many foreign economic ministers, as well as Republican leaning economists, have labeled the Fed's plan to be inflationary. The result to date has been an increase in real interest rates as investors demand greater yields in exchange

debt has come in the form of taxable BABs during 2010. Should the BABs program expire (or should the subsidy be reduced materially), a significantly greater supply of traditional longer term tax exempt municipal bonds can be expected in 2011. This has caused increased issuance of BABs in 2010 Q4, some of which may have otherwise been issued in 2011. Continuing the Bush tax cuts for higher income taxpayers further reduces the demand, albeit slightly, for the potential increased supply of tax exempts.

Aggravating the problems currently facing the municipal bond market are the ongoing comments by non-market specialists to paint all municipal entities as being in dire straights. Certainly, states, and ultimately local government entities, will struggle to balance their budgets as fiscal relief from the Federal government will be diminished just as their primary sources of revenues are only beginning to recover. And it is true that California and Illinois, in particular, continue to strain to resolve their problems, while a handful of smaller isolated issuers (e.g. Harrisburg, PA, Menasha, WI) are facing default due to unique circumstances. The resulting "headline risk" should persist in 2011, but the potential for default contagion remains remote.

We believe that positive seasonal technical supply/demand factors in the municipal markets should add stability to the markets at the beginning of 2011. We are continuing to combine an overweighting of short duration (one to two year) bonds and callable issues with attractive yields with maturities in the 2017 to 2021 range. The latter is in the maturity range that should benefit from the QE2 purchases. Our purchases will continue to focus on well researched essential purpose revenue issues and dedicated tax bonds, while avoiding most state general obligations and appropriation debt.

Gary Gildersleeve is a Partner and Fixed Income Portfolio Manager at Evercore Wealth Management. He can be contacted

– remains under .05%. These low yields should continue to impel investors to move cash out into short maturity bonds. The result should be that rates out to two years may stay near historic lows with a flatter yield curve in shorter maturities relative to longer maturities. That should remain the case until the Federal Reserve shows signs of increasing the Federal Funds rate. The fact that yields for short maturity tax exempt bonds exceed those of similar maturity U.S.

for the QE2's uncertain impact.

Adding to the pressure for higher interest rates for longer maturity municipal bonds is the lack of an extension of the taxable Build America Bonds, or BABs, program in President Obama's compromise. BABs, which currently offer a 35% subsidy to municipal issuers from the Federal Government, provide the greatest benefit to municipal issuers in longer maturities. Through November, over \$100 billion of municipal



TIPS: Not the Best Inflation Hedge

by **BRIAN POLLAK**

Strong performers since they were first issued in 1997, Treasury Inflation Protected Securities, or TIPS, are unlikely to maintain their past level of return even as inflation rises.

TIPS, which are guaranteed by the U.S. Treasury, pay investors through two components: their real interest rate, and through the adjustment of principal to inflation as measured by the Consumer Price Index, or CPI. The principal is adjusted for inflation semi-annually and the coupon is paid on this adjusted amount. The investor will always receive at least the original principal back at maturity, offering protection from deflation. But deflation could reduce the return on older TIPS with inflation-adjusted principal that is higher than the original principal.

Investors in TIPS can benefit if real interest rates go down (driving the price of the security up) or if actual inflation, as measured by CPI, is positive. If actual CPI exceeds expected inflation, calculated by the yield differential between TIPS and nominal Treasuries (known as the inflation breakeven), the TIPS' return will outperform that of nominal Treasuries.

Historically, investors received an attractive real interest rate to invest in 5- and 10-year TIPS, averaging 2.1% and 2.6%, respectively, since first issuance. Most of this period has also been characterized by moderate levels of inflation, with CPI averaging 2.4% since 1997. Despite not

needing inflation protection, an investor who purchased TIPS beginning in 1997 would have still enjoyed a solid annualized rate of return close to 7% (as measured by the Barclays TIPS Index), approximating that of nominal Treasuries. This return was driven primarily by persistently declining real interest rates (as illustrated in the chart below).

At the end of November 2010, real rates were at -0.21% and +0.65% for 5- and 10-year TIPS, respectively, both near all-time low levels. Very low or negative real interest rates theoretically imply a very low economic growth rate over and above inflation. Negative real interest rates also guarantee that the investor will lose wealth in terms of purchasing power. But what else could these low rates tell us? Perhaps that investors are willing to pay a high premium for inflation protection, or possibly that pressure from the Federal Reserve's asset purchase program is pushing real rates below efficient market levels. Either way, it is our view that real interest rates are improbably low, based on even fairly conservative estimates of future economic growth.

If real rates rise materially and inflation as measured by CPI continues to be modest

for a prolonged period, investors in TIPS will experience a decline in the market value of their bonds. If inflation exceeds current expectations, which are currently around 1.5% and 2.1% for 5 and 10 years, respectively, TIPS will represent a better investment than nominal Treasury bonds, but may underperform CPI if real rates are also rising.

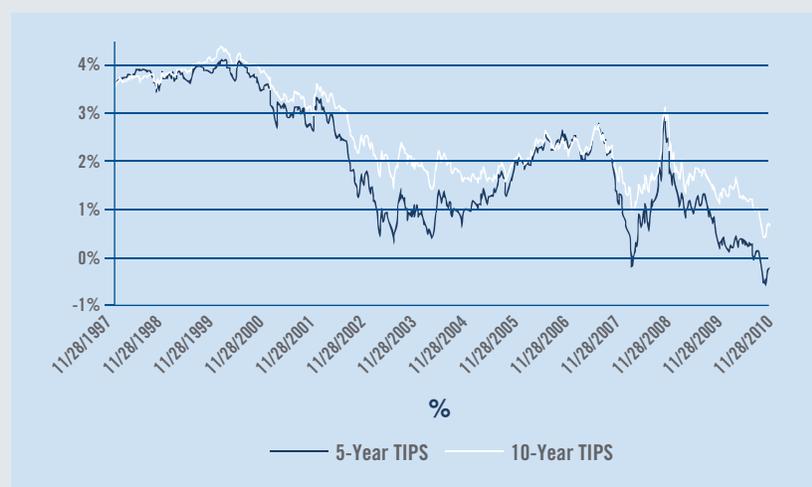
Within Evercore Wealth Management's Diversified Market Hedges, or DMH, accounts, we focus on protecting clients' portfolios from an environment where both equity and nominal bond prices fall in unison. Until recently, we have owned TIPS as a core holding. But recent appreciation as a result of declining real interest rates prompted us to sell our TIPS holdings in DMH accounts. While the prospect of robust inflation is as great a risk as ever, we believe that the potential price appreciation in TIPS from a further decline in real interest rates is very limited and that there is significant downside risk if real rates rise materially.

Today, we see other securities that will work at least as well or better as a hedge against inflation, and generate a more attractive current return or more near-term upside potential. Examples include non-U.S. dollar denominated foreign bonds with high yields, gold, leveraged loans that adjust with LIBOR, and equities of companies that can quickly re-price or that have undervalued productive assets.

We continue to recommend holding TIPS within tax deferred accounts, as they should hold their value relative to nominal bonds. But for investors concerned about rising inflation, we see superior alternatives.

Brian Pollak is a Fixed Income Portfolio Manager at Evercore Wealth Management, responsible for managing taxable bond investments. He also serves as Co-Manager of the Diversified Market Hedges strategy and is a member of the Investment Committee. He can be reached at brian.pollak@evercore.com.

TIPS Real Yields



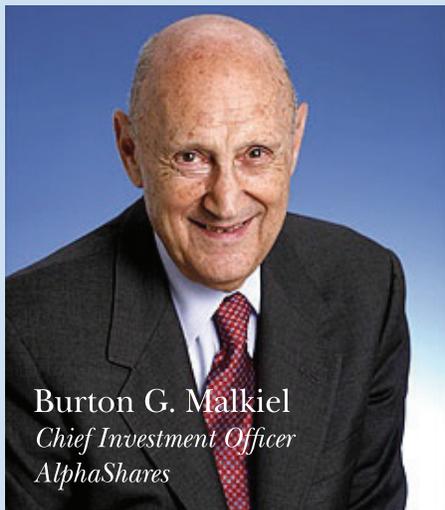
Source: Bloomberg Data



AlphaShares on Investing in China

An interview with Burton G. Malkiel at AlphaShares

Editor's note: Evercore Wealth Management supplements our strengths in core equity and core fixed-income investment management with carefully selected access to external managers across multiple asset classes and investment styles. AlphaShares is an investment manager we have chosen to increase our direct investment exposure to China. The AlphaShares broad-based, all-capitalization index exchange traded fund, or ETF, trades under the ticker symbol YAO. The fund is comprised of all investable publicly traded Chinese companies with market capitalizations above \$500 Million. It is also designed to give investors appropriate diversification at both the stock and sector level.



Burton G. Malkiel
Chief Investment Officer
AlphaShares

Here we interview Burton G. Malkiel, the Chief Investment Officer of AlphaShares and the Chemical Bank Chairman's Professor of Economics at Princeton University. Dr. Malkiel is the author of the investment classic, **A Random Walk Down Wall Street**, and more recently, **From Wall Street to the Great Wall**.

Q: *Is China's fast pace of economic growth sustainable?*

A: It is very likely that China will continue to grow rapidly for at least the next decade if not longer. While the eastern part of China is now well developed, the vast central and western regions are still largely underdeveloped. There are probably 500 million unemployed

or underemployed people living in those regions who are anxious to enjoy some of the riches that have been created in the east. Many are educated, motivated and highly entrepreneurial. And Chinese government policy has begun to promote growth in the region by investing in infrastructure such as power plants, roads and high-speed rail service. The Chinese growth miracle is only in the middle innings.

Q: *Statistically, higher GDP growth rates do not always translate into higher stock market performance. Why is China different? Are stock valuations a concern?*

A: Fast economic growth does not always create generous security returns. Indeed, there have been periods in China's history where equity returns have been negative even while real economic growth continued rapidly. But poor periods for equities always followed periods of excessive common-stock valuations. Equity returns have corresponded to company growth rates whenever initial valuation metrics were moderate at the start of the measurement period. Since Chinese equities today are quite reasonably priced, future economic growth is likely to be associated with generous future equity returns. Economic growth does translate into generous stock-market returns when valuations provide attractive entry levels as they do now.

Q: *What effects do you think the yuan peg has on valuations?*

A: China's growth should be sustainable in the future but the composition of that growth is very likely to change. Thus far, the country's growth has relied largely on investment spending and increased exports. But China's high-investment/GDP ratio is not sustainable and the rest of the world, suffering from high unemployment, is unlikely to allow China to increase its exports at its historical

rate. At the same time, there is increasing international pressure of China to increase the value of its currency. As China grapples with rising inflation, its government is likely to see a revaluation of the yuan to be in its own domestic economic interest as well.

Q: *What are the investment implications as China transitions from an export-led economy to a more domestic-focused economy?*

A: Fortunately, China has a feasible adjustment mechanism to help change the composition of its economic activity toward consumption and away from investment and export spending. China's consumption expenditure is, at 37%, just over half the 70% rate in the United States. As the Chinese consumers become wealthier, they will demand more nondurable and durable goods. With the encouragement of the government, China's automobile industry now produces more cars than the United States. And the Chinese government has begun to build a social safety net (medical coverage, unemployment insurance and retirement plans) designed to reduce the need to save. Consumption expenditures have recently been growing much faster than overall GDP and are expected to continue to do so.

Q: *As you thought about the Chinese investment opportunity, what were the other issues that you had to consider?*

A: While a simple world index fund is a useful instrument for many investors, there are structural reasons that give China far too little weight in the fund. Global indexes are "float" weighted and China gets only a 2% weight in such indexes. All the so-called "A" Chinese shares that trade in Shanghai and Shenzhen are excluded from the float because they are not freely available to international investors. Also, the Chinese government owns a significant share of the stock of many companies such as the banks

and oil companies. Since government-owned shares do not trade freely, they are excluded from the float.

Q: Given your predisposition towards efficient markets, what are your thoughts on Evercore Wealth Management's approach of overweighting China versus a global equity market cap benchmark?

A: While China represents about 13% of world economic output, most investors have little or no exposure to China in their portfolios. Why should an investor want to be underweighted in the most rapidly growing major economy in the world? I believe that most investors are seriously underweighted in Chinese equities.

Q: Why are ETFs excellent instruments to obtain exposure to China? What are the advantages of YAO?

A: ETFs such as YAO are well diversified and relatively low expense index funds that should prove to be useful vehicles for individual investors to benefit from China's continued growth. YAO provides an excellent vehicle to enable investors to share in the future growth and the structural changes I anticipate for the Chinese economy. YAO has many advantages over the FXI ETF that represents the FTSE-Xinhua 25 stock indexes. YAO is much better diversified than FXI. It contains about 150 stocks versus 25 in FXI. No stock in YAO is allowed to represent more than 5% of the portfolio and no industry can have more than a one-third weight in the index. FXI, on the other hand, has almost half of its portfolio invested in bank stocks and close to 85% of the portfolio invested in banks, oil and telecom companies. This means that FXI is concentrated in Chinese companies that are substantially government-owned, whereas YAO has a substantial weighting in the smaller, more entrepreneurial China companies. FXI has no consumer stocks in the portfolio and essentially no technology

stocks. YAO has almost one quarter of its portfolio in consumer and technology stocks that are likely to be the fastest growing sectors of the economy. FXI has no U.S.-listed Chinese company stocks in its portfolio. Thus, a company like Baidu.com (the Chinese Google) is not part of FXI, whereas it is included in YAO. While past performance can never be used to accurately represent the future, YAO, since its inception, has outperformed FXI with less volatility.

Q: What is your outlook now for the Chinese stock market?

A: Price-to-earnings multiples for Chinese stocks available to international investors in diversified ETFs are in the mid-teens, based on 2011 estimates. Moreover, so-called PEG ratios (the ratios of price-to-earnings multiples to estimated long-term growth rates) and other valuation indicators are extremely attractive. Chinese equities are available today at valuation metrics that have proved extremely attractive in the past. Longer term, China is likely to be the most rapidly growing economy in the world, for at least the next decade. Over time, the Chinese currency is likely to continue to appreciate against the U.S. dollar, giving investors extra returns.

Evercore | Wealth Management News

Evercore Wealth Management Hosts China Discussion in San Francisco

Iain Silverthorne and colleagues in the San Francisco office invited clients to a presentation on investment opportunities in China on December 15th. The event, which was oversubscribed, featured Burton Malkiel, the author of *A Random Walk Down Wall Street*, and more recently, *From Wall Street to the Great Wall*. Dr Malkiel, who is the chief investment officer of AlphaShares, is interviewed in this issue of Independent Thinking.

Jeff Maurer Addresses Reuters CEO Panel

Evercore Wealth Management CEO spoke at the annual Reuters CEO panel in New York City. His comments on the U.S. tax outlook, the municipal bond market and asset allocation and portfolio management for individual investors were featured in a range of publications. **To view recent Evercore Wealth Management media coverage, please visit:** <http://evercorewealthmanagement.com/news.asp>.

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