Opportunity, said Thomas Edison, is missed by most people because it is “dressed in overalls and looks like work.” The opportunity for our newly elected and reelected – but still divided – leadership will be to recognize that compromise is the better part of valor now and that it is time to come together to address budget reform. The opportunity for investors is to manage through ongoing fiscal and market uncertainty, identifying opportunities for growth and yield across the markets and evaluating the impact of changing tax legislation at home.

This takes hard work. But the payoff could be considerable. Already, there are two powerful trends developing in the United States that will lay the foundations for strong economic growth, should Washington come to its senses soon. Structural changes in energy production and a revival in housing suggest that forecasts of mediocre growth and continued political turmoil may well be overstated.

Indeed, the United States may be the greatest beneficiary of an upturn in the global economy when some of the political uncertainty, both at home and abroad, is resolved. It will take years to put the financial reversals that started in 2008 (continued on page 3)
Much has been made of the dangers for the American economy if – despite the clear will of the electorate in both parties – the politicians fail to craft a compromise in the next two months that will pull us back from the brink of the much discussed fiscal cliff. Less has been said about the opportunities within grasp if they do.

Those opportunities, as John Appruzese and others discuss in this issue of Independent Thinking, are large. Dysfunctional government has been the biggest reason to be bearish about the United States. Take that away and the prospects for growth are better than they have been for years.

We are already seeing a surge in oil and gas production, gains in domestic manufacturing and, at last, a revival in housing. We are now starting to see resurgence in banking, with bank lending to businesses approaching record highs. And we may yet see debt reduction.

The expiration of the Bush tax cuts at the end of this year, barring intervention by Congress, is a wealth planning challenge, as Chris Zander discusses here. But it could concentrate minds in Washington and force even the most trenchant of political foes to the negotiating table, resulting in a balanced deficit-reduction program that could boost investor confidence around the world in the United States.

At Evercore Wealth Management, our tasks in this environment are complex, but our goal is simple. It is to help our clients prosper whatever compromise the President and Congress succeed in fashioning, and to protect their portfolios if they continue to struggle or reach no compromise at all. That is why we keep our bond durations short and why we allocate to our Diversified Market Hedges Strategy, as we continue to invest with confidence across other asset classes. We are optimistic that our representatives will craft a compromise.

Joining us in our work will be three new partners, two in San Francisco and one in Los Angeles, and a total of 11 new employees. Our acquisition of Mt. Eden Investment Advisors, announced on November 7, expands our presence along the West Coast and adds depth and breadth to our national firm. We anticipate the transaction to close before the end of the year and look forward to welcoming our new colleagues.

We are delighted with our progress at Evercore Wealth Management as we approach our fourth anniversary. We remain very thankful to our clients for placing their trust in us. We will continue to work hard every day to keep that trust.

Jeff Maurer
Chief Executive Officer
completely behind us, but a number of U.S. companies have managed very successfully throughout, and their accomplishments are starting to reverberate through the broader economy.

Innovations in the energy sector in particular are shaping a virtuous circle of economic and competitive advantage. North American companies are taking the lead in exploiting new technologies in horizontal drilling and shale fracturing. The additional supply of natural gas in the region, which is not easily exported, has caused the price of natural gas in the United States to fall to a level that is 70% less than the cost in the rest of the developed world. This competitive advantage is leading companies to build new manufacturing capacity in the United States and Mexico, instead of in China and other countries with lower labor costs but higher energy costs. Eventually, of course, the technology will spread around the world and help increase cheap energy supplies for other economies as well, but North America will enjoy a powerful competitive advantage for many years to come.

We have also most likely seen the bottom of the U.S. residential real estate market after six long years. Prices have started to rise and the supply of unsold homes has fallen. Up to three million household formations have been delayed since the beginning of the financial crisis, caused mainly by unemployment, resulting in potentially enormous pent-up demand. At the same time, the Echo Boom, the children of the baby boomers, is entering the prime age for household formation, which should further stimulate housing starts. Healthy economic recoveries in the past have always depended on a strong surge in new home builds, which generates many new construction jobs. At present, home affordability has never been better and consumers have been quietly repairing their balance sheets by reducing total debt outstanding.

New manufacturing capacity as a result of cheap natural gas and a revival of new home builds could generate enough new jobs to get the economy moving at a healthy pace. And there are plenty of well-managed American companies in other sectors; Tim Evnin takes a look at several of them on page 8. But managing risk in this environment is at least as challenging as identifying the opportunities. For many individual and family investors, changing tax legislation is the biggest portfolio risk at present.

Normally, as we approach the end of the year, we comb through portfolios looking for losses that can be realized to reduce the tax bill on realized gains taken

Federal Income Tax Landscape

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Federal Marginal Tax Rate for Ordinary Income</td>
<td>35%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Long-Term Capital Gains (assets held &gt; 1 year) – Top Bracket</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>Long-Term Gain from Collectibles (art, precious metals, etc.)</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td>Short-Term Capital Gains (assets held &lt;1 year) – Top Bracket</td>
<td>35%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Qualified Dividend Income Tax Rate – Top Bracket</td>
<td>15%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Medicare Surtax</td>
<td>0%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

- Year 2013 tax rate changes will take effect beginning in 2013 absent further legislation.
- The Medicare Tax is part of the Health Care Reform Act passed in 2010. As it applies to individuals, for taxable years beginning January 1, 2013, a tax equal to 3.8% will apply to the lesser of:
  A. Your net investment income for the year, which includes interest, dividends, and net capital gains (including gain on sale of investment property as will be discussed further) or,
  B. The excess (if any) of your adjusted gross income in that taxable year over the threshold amount of $250,000 for married couples filing jointly and $200,000 for single filers.
through the year. However, the expiration at the end of 2012 of President Obama’s Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, coupled with sunsetting of the Bush Tax cuts, means that the opposite strategy may be called for. Accelerating realized gains this year may make sense for many taxpayers if, in fact, capital gains tax rates do go up for the foreseeable future.

In a similar vein, investors have just a short window of opportunity now to transfer substantial wealth. The current estate tax, gift tax, and generation skipping tax exemption amounts for 2012 are $5,120,000 each, while the top marginal federal tax rate for each is 35%. However, unless Congress acts by January 1, 2013, the estate tax and gift tax exemption amount will be reduced to $1 million, while the GST exemption will be reduced to approximately $1.36 million (after being indexed for inflation). The top marginal federal tax rate would be increased to 55%.

With qualified dividend tax rates set to soar to as high as 43.4%, investors will want to reassess their after-tax cash flow from dividends, which may result in a lower emphasis on dividend-paying stocks.

John Apruzzese and Chris Zander contributed to this article. John is a Partner and the Chief Investment Officer at Evercore Wealth Management. He can be contacted at apruzzese@evercore.com. Chris is a Partner and Head of Wealth Planning at the firm. He can be contacted at zander@evercore.com.

### Federal Estate, Gift, Generation Skipping Tax Landscape

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual Exclusion</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single Person</td>
<td>$13,000</td>
<td>$14,000</td>
</tr>
<tr>
<td>Married Couple/Gift Splitting</td>
<td>$26,000</td>
<td>$28,000</td>
</tr>
<tr>
<td>Gifts to Non-U.S. Citizen Spouse</td>
<td>$139,000</td>
<td>$139,000</td>
</tr>
<tr>
<td><strong>Lifetime Gift Tax Exemption</strong></td>
<td>$5,120,000 (indexed (with portability))</td>
<td>$1,000,000 (no portability)</td>
</tr>
<tr>
<td><strong>Minimum Gift Tax Rate</strong></td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td><strong>Estate Tax Exemption</strong></td>
<td>$5,120,000 (indexed (with portability))</td>
<td>$1,000,000 (no portability)</td>
</tr>
<tr>
<td><strong>Minimum Estate Tax Rate</strong></td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td><strong>Generation Skipping Tax (GST) Exemption</strong></td>
<td>$5,120,000 (no portability)</td>
<td>$1,400,000 (indexed (no portability))</td>
</tr>
<tr>
<td><strong>Maximum GST Tax Rate</strong></td>
<td>35%</td>
<td>55%</td>
</tr>
</tbody>
</table>

- Without a further act of Congress, in 2013, the federal estate, GST, and gift tax rates, rules and exemptions will return to those in effect prior to the enactment of EGTRRA. The 2013 GST exemption will be indexed for inflation. Note the annual exclusion amounts are indexed and increased in increments of $1,000.
- This chart does not include any applicable state estate tax rates, rules or exemptions.
Fresh after the 2008 financial crisis, Evercore Wealth Management opened its doors in midtown Manhattan. Self-described “refugees of larger organizations,” they advise almost exclusively families with an average $10 million per account. Born into such a traumatic climate, it’s no wonder Evercore, with $3.6 billion in assets under management, had a lot to say about risk when we chatted with them at their office last week.

“We’re really thinking about risk first, as opposed to returns,” said Evercore partner John Apruzzese, when thinking about client portfolios. In simpler times, it was common to see a 60-40 portfolio, (60% equities, 40% bonds); “we adjusted that so equities is more like 50%, in reaction to volatility, and the expectation volatility would continue.” That leaves 25% for bonds and 25% for alternatives.

Evercore also doesn’t measure portfolio risk by standard deviation, that is, a measure of a portfolio’s volatility based on how far it strays from average returns. The firm has elected to replace that “misleading” convention as well, preferring instead to calculate risk by “maximum draw down,” which is a volatility measurement from the peak of the portfolio to the trough; Evercore’s aim is to get that spread within 25%. If a client is not comfortable losing 25%, the risk needs to be dialed down. In describing investors, Evercore CEO Jeff Maurer, former CEO of U.S. Trust, brought up the old maxim, “Would you rather eat well or sleep well?” “In the last five years,” he contends, “they’ve said, ‘sleep well.’”

But, in such a difficult investment environment, “you can’t earn a real return in traditional, very low-risk asset classes,” Apruzzese says. In fact, “there’s a penalty for being overly conservative.” Clearly, the return on cash is near zero, and inflation is more than zero, “let’s call it 2%. So in cash you’re losing [almost] 2% in real terms, and in high quality municipal bonds, you’re lucky to earn anything more than the rate of inflation.”
So, how to generate income? Apruzzese says you can take on duration risk, that is, buy very long-term bonds. “But,” he warns, “that’s not very satisfying since those rates are low and you take a lot of interest rate risk.” Evercore is more willing to take on credit risk. “We want to do it in a way where we can get some very good yields and not have any interest rate risk.” So they like floating interest rates, including some portfolios that invest in loans that banks have made to corporations. They’re not investment grade, “but they are senior secured, well-diversified. You can currently get something like 5%.” There’s some credit risk, “but we think it’s moderate.”

There’s also been some interest in non-government guaranteed mortgages, where there are opportunities to earn 7% or 8%, Apruzzese says. “You need a good manager selecting the mortgages,” which should be managed in such a way that limits the interest rate risk.

Why not high-yield stocks? “It looks to us like there’s been so much interest in high-yielding stocks, that they actually look expensive.” But one area where Evercore makes an exception is for stocks in emerging markets. “We’ve invested in an ETF that does emphasize dividends, and we don’t think dividends have been chased in emerging markets,” where there are large, stable businesses benefiting from fast economic growth.

For another high-income play with no interest rate risk, they’ve zeroed in on middle market lending. “Banks have gotten out of that business. GE Capital and CIT were doing it. They got burned in 2008,” Apruzzese explains.

Some private firms now raise equity capital and lend into that market, targeting companies with a cash flow of $5-$50 million. These loans have high interest rates.

The senior part of the loans are earning around 8%; the unsecured tranche, or mezzanine, earns around 15%, according to Apruzzese. “We’ve identified a firm that does both.” For quick and consistent income with no interest rate risk, he cautions, you have to be comfortable with illiquidity and credit risk. The money is invested via a limited partnership with a duration of about 6-9 years.

Our takeaway from Evercore? In conventional wisdom and investment formulas lurk great risks.
As the clock runs out on the enhanced estate and gift tax exemptions, investors are taking a hard look at their goals, calculating whether they can afford to transfer wealth – or afford not to.

Unless Congress acts before the end of the year, the exemption for estate and gift tax will be reduced to $1 million from $5 million and the generation skipping tax, or GST, will be reduced to about $1.4 million, indexed for inflation. At the same time, the top rate for gift tax and GST will rise to 55% from 35%. In theory, this is a critical time to transfer wealth. In practice, however, the decision isn’t so easy. Here are a few questions to consider:

Do you have sufficient assets to support your lifestyle and other personal financial objectives? If so, consider maximizing the use of the gift tax exemption and make lifetime gifts to family members before the end of the year. 2012 transfers and your prior transfers can total $5.12 million for individuals and $10.24 million for married couples.

Are you prepared to give your grandchildren funds? If that makes sense for you and for them, at this stage in their lives, a generation skipping tax exemption combined with the gift tax exemption of $5.12 million can fund trusts, with assets compounding over multiple generations free of transfer tax. Different trusts and assets can be allocated to individual beneficiaries and objectives set for each.

Do your children have enough? If you are concerned that your own children may not have adequate funds if you take advantage of the GST window, you should employ trusts that can be designed with provisions that allow an independent trustee to make distributions to your children or your grandchildren.

Just how confident are you that you can afford to give? If you want to retain access to the funds in the event of a financial emergency or aren’t sure that you can irrevocably part with the maximum gift, consider creating spousal and family exempt trusts, or SAFE trusts. These trusts contain provisions that permit distributions to the grantor’s spouse under a trustee’s discretion. If you decide to add your descendants as potential beneficiaries of the trust, the trustee could also make a distribution to them free of gift tax. It is important that your advisors work with your estate-planning attorney to avoid setting up trusts deemed reciprocal under IRS regulations.

What is the most efficient method of wealth transfer in this interest rate environment? Historically low interest rates make leveraged techniques appealing as a way to transfer significant amounts of wealth. For example, the use of a grantor retained annuity trust or a sale to an intentionally defective grantor trust could be attractive for the right situation. Under the Obama tax proposals, these strategies could possibly disappear or be significantly limited after 2012. In the interim, they are particularly useful for those who are more comfortable giving away the future appreciation of a particular portfolio of assets in lieu of departing with the current principal.

It’s also worth noting that illiquid, long-term assets are ideal assets to transfer if you do not need the asset to sustain your lifestyle. Assets in this category include (but are not limited to) private equity, venture capital funds, private real estate funds, closely held business interests, individual personal and rental real estate and raw land. These assets may possibly command a lower valuation given their illiquid nature. Keep in mind that after 2012, these discounts may not be available.

Now is the time to act. Please discuss with the Evercore Wealth Management partner you work with or Chris Zander, the national head of strategic wealth planning. He can be contacted at zander@evercore.com.
Several key short-term issues are favoring the United States over other markets. The most significant is the resurgence of the domestic oil and gas industry. This is not only creating thousands of jobs and wealth but also helping to dramatically lower costs for a range of businesses. This new level of low natural gas prices is leading to a change in many companies’ plans as they pivot from overseas investments to U.S. ones. Plans for several multi-billion-dollar chemical plants, including one by Celanese Corp., have been announced, with the primary rationale being low-cost natural gas feedstock.

Other, shorter-term issues include a new interest among companies to bring critical manufacturing closer to end markets, avoiding supply chain disruption and rising transportation costs. This, combined with a slack jobs market and low wage pressure, is creating strong incentives to hire and reinvest at home. This trend has not shown up yet in the employment numbers, but we believe it will soon.

At present, U.S. corporate management is the best in the world. They manage better and repeatedly out-innovate rivals in both simple and complex tasks. Despite being labeled by many industry critics as “short-term” focused, there are some long-tenured management teams that have created hugely successful enterprises. There are obvious exceptions to this observation, with the recent financial crisis the most glaring, but most U.S. management teams have done an excellent job steering through a very difficult time. Many companies, having survived these last several years, are now poised to continue to grow and prosper.

Celanese is a specialty chemical company that has an extensive overseas business, notably in China. While the opportunities overseas are still very significant, the company recently announced plans to build a large facility in Texas to take advantage of low natural gas prices to produce their critical feedstock, methanol. This will pour hundreds of million dollars into the local economy and create several thousand jobs during and after construction. Celanese has also been investing heavily in new technologies and has patented a process for manufacturing industrial or fuel ethanol from coal or natural gas at substantially lower prices than any biomass-based process. Low-cost feedstock and innovation should accelerate earnings growth.

The TJX Companies, Inc., or TJX, is a quintessential American company. Founded in Massachusetts and tracing its history back at least 40 years, TJX is an off-price retailer. In retailing in general, and especially in this niche, it is hard to innovate and differentiate stores from the competition. But TJX has been doing that for decades, led by only three different executives since it went public in 1987. The company generates returns on invested capital of over 40%, invests for growth, and still manages to reduce the share count and pay a dividend that has grown every year for the last ten.

Western Digital Corp. is another U.S. company with a long-tenured CEO that has managed to prosper, and now dominate, an intensely competitive market by continuing to innovate, execute and attend to customers. The hard disk drive market is littered with failed companies over the past decades but now, after significant consolidation, two U.S. companies have over 75% market share, with Western Digital controlling over 40% in most products. (The other is Seagate Technology Inc.) Despite a more than sixfold growth in cash flow over the last ten years, the best might still be ahead for this California-based company. The duopoly-like market structure should help pricing and, despite a shift to different storage technology in some markets, the company predicts that 85% of data needed for manipulation will still be stored on rotating magnetic devices 7-10 years from now. This should present a large and long-term path to profits and cash flow.

Tim Evnin is a Partner and Equity Portfolio Manager at Evercore Wealth Management. He can be contacted at evnin@evercore.com.
Fiscal policy is likely to remain uncertain, even now that we know who our representatives are. A divided Congress means that any resolution to the fast-approaching fiscal cliff will be difficult.

Monetary policy, on the other hand, seems more certain, as the re-elected President Obama is less likely to seek change at the helm of the Federal Reserve. But monetary policy now is a function of fiscal policy: If Congress cannot negotiate a balanced deal that is positive or even neutral for growth, monetary policy could remain extremely loose.

Understanding the relationship between fiscal and monetary policy and its possible impact on asset values is a key factor now in protecting investment portfolios.

The Federal Reserve in September initiated the third round of its large-scale asset purchase program, also known as quantitative easing, or QE3. The Fed plans to expand its balance sheet by approximately $40 billion a month as it purchases mortgage-backed securities. Simultaneously, the Fed will continue its “Operation Twist” program, selling short-dated Treasury securities and buying longer-dated ones.

The theory goes that, as the Fed purchases Treasury and mortgage-backed securities, longer-term interest rates for these assets will decline. Prices of other high-quality bonds that are influenced by Treasury yields, including corporate and municipal debt, will also rise, allowing corporate and municipal entities access to lower-cost funding but diminishing their appeal for investors. They will turn instead to relatively high-risk, high-return assets, such as high-yield and emerging market debt, and global equities. The ensuing rise in wealth for investors – the so-called “wealth effect” – will boost consumer confidence and spending power, leading to a virtuous cycle of both real and nominal growth.

That’s the theory. But is this policy meaningful in practice? Previous rounds of quantitative easing have boosted stock prices, albeit with diminishing efficacy. The S&P 500 rose by about 50% during the first round and by
about 25% in the second. Quantitive easing has had a similar impact on both inflation and inflation expectations; both rose during the programs and declined afterward. While it seems that QE has boosted nominal growth, the evidence is less robust when linking QE to real growth.

Although we have seen some empirical evidence that QE has been beneficial for both equity markets and inflation, it is less clear that it has any significant impact on real GDP growth in the economy.

This round of QE potentially presents a positive catalyst for the stock market to move higher. However, there are a few reasons to be worried that it could instead decline. At writing, the market is not in or near bear market territory. In fact, it is at a post-crisis high water mark. Indeed, it could be argued that any QE rally has already occurred, with the S&P 500 up over 16% year to date through Election Day.

But again, it comes back to fiscal policy for investors. Fiscal policy is another key risk for investors. Even if Congress pulls the country back from the edge of the fiscal cliff, tax increases, spending cuts, or a combination of the two may drag on GDP in 2013. The fiscal outlook in Europe is even more alarming, as policymakers implement austerity plans that both cut spending and increase taxes, grinding the economy into recession. The U.S. equity markets are by no means beholden to the European economy, but we also see evidence of a harder landing than expected in China. At the same time, U.S. companies have slowed hiring and spending plans as a result of the uncertain tax and regulatory policy at home.

As third quarter earnings results already suggested, all of these factors point to risks for corporate earnings, both through the end of the year and in 2013. If corporate earnings continue to weaken, equity markets are likely to fall from their current perch.

The Diversified Market Hedges team has concerns about both the inflationary impact of money printing and the deflationary impact of tightening fiscal policy. Our goal is to design a portfolio to protect investors if the economic environment shifts to either extreme. Our strategy allows us to take positions in any liquid market or instrument to mitigate risk. Long and short investments are made in currencies, bonds, stocks, precious metals, industrial commodities, managed funds and derivatives.

Brian Pollak is a Fixed Income Portfolio Manager and one of the Managers of the Evercore Wealth Management Diversified Market Hedges Strategy. He can be contacted at brian.pollak@evercore.com.
Defensive Assets
Bond Concerns: Yields, Capital Gains & Tax Exemption

by Gary Gildersleeve

With the Presidential election now behind us and political gridlock set to continue, the fixed income market’s focus now turns to the fiscal cliff and whether it can be resolved in the limited time before the December 31 deadline. Combined with the global economic slowdown (especially in China), the continuing Eurozone crisis and expected recession there, and the anemic domestic U.S. economy, the persistent low interest rate environment is likely to continue for the foreseeable future.

Discussions of how these hurdles should be approached, however, may lead to increased price volatility. For municipal bonds in particular, the issue now is yield.

Investors primarily purchase municipal bonds for two reasons: safety and income. Concerns about municipal credit quality have largely abated since the winter of 2010-11, as the calamity predicted by one well-known analyst never materialized and the number of defaults nationally declined in spite of the well-publicized problems with a handful of California cities.

Municipal bond yields touched historic lows in the third quarter of 2012 and remain near them today. As a result, nearly all outstanding municipals trade at a premium to their par, or face, value. But what is the yield that investors are earning? There are actually several measures of yield, although they are not always readily discerned.

Three yields of interest to municipal bond investors are: current yield; yield to maturity at cost; and yield to maturity at market. Most long-term fixed income holdings have a fixed rate and specified maturity or put date. Current yield for a bond is derived by dividing the coupon by the current price (similar to dividing a stock’s dividend by its price). Current yield is normally very deceptive, as it does not reflect the total return the investor will earn over the life of the bond.

Specifically, with the majority of outstanding bonds possessing coupons of 5% or higher and priced at a premium, current yield fails to account for the amortization (or depreciation) of the premium and can lead investors to believe they are earning more than they really are. It provides limited informational value, especially as a high coupon most likely cannot be replaced in the current environment when a bond matures or is called.

The primary yields of importance to individual investors are yield to maturity (or call) at cost and yield to maturity (or call) at market. The former will be earned by an investor, based on the original cost, over the life of the holding to maturity, or, if callable, at a call date. The latter is determined by the current market price and indicates the return that will be earned from the current time to either maturity or a call.

The following bond, purchased in December 2011, serves as an example of the three types of yield mentioned above.

**Figure 1: Puerto Rico Sales Tax 5% due 8/1/2021**
*Ratings: Aa3/AA-

<table>
<thead>
<tr>
<th>Purchase Data</th>
<th>Market Data</th>
<th>Maturity Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td></td>
<td>8/1/2021</td>
</tr>
<tr>
<td>Price</td>
<td>$113.448*</td>
<td>$122.12</td>
</tr>
<tr>
<td>Current Yield</td>
<td>4.34</td>
<td>4.09</td>
</tr>
<tr>
<td>Yield to Maturity</td>
<td>3.22</td>
<td>2.20</td>
</tr>
</tbody>
</table>

*Amortized cost a/o 11/7/2012

The bond example presents several of the dilemmas facing fixed income investors today:
The yield to maturity at purchase, or cost (3.22%), for the bond above, as with most holdings purchased before 2012, is higher than the yield to maturity at market (2.20%) for the same issue today. (This is especially true for bonds rated less than triple-A, as the demand for yield has caused interest rates for lower rated issues to decline more than higher rated ones.) The yield to maturity at cost, however, is the yield on which an income-oriented investor should be focused, as it helps to provide an approximation of what can be remitted without, in effect, dipping into principal. While investors were faced with a relatively low interest environment in 2011, purchases made prior to 2012 provide yield that is not currently available and are granting a cushion against losses should interest rates move higher.

The current yield, both at purchase (4.34%) and at market value (4.09%), significantly exceeds the yield to maturity and is very deceptive since it does not reflect amortization of principal. Further, it will increase as the bond approaches its face value at maturity, at which time the coupon interest cannot be replaced with the proceeds received, barring a significant rise in yields from present levels.

Capital gains are a factor. The decline in municipal bond yields has created unrealized capital gains, which can often be significant and should enter into an investor’s decision when considering sales. This consideration is compounded when the capital gain of a holding (such as in Figure 1) is not yet long term and the Federal tax rate that will apply is 35% (ordinary income/short-term gain) and not the current 15% long-term capital gain rate. Note that the resulting capital gain tax to be paid reduces the principal from a sale that can be reinvested. The cost of realizing the short-term gain of 8.672 points in Figure 1 would be 3.13 points versus only 1.30 if the holding period exceeded one year. Note also that the likelihood of both the short- and long-term capital gains rates rising has increased with the re-election of President Obama.

Municipal bonds may further be impacted by renewed discussion of tax reform. President Obama has proposed that the benefit be capped at the 28% marginal tax rate. This would be a negative for municipal bond prices, especially since there is no guarantee that the cap could not be lowered in the future. Conversely, the likelihood of higher marginal income tax rates and the inception of the 3.8% tax on investment income and capital gains via the Affordable Care Act increases the relative attractiveness of tax-exempt bonds. While we believe that the threat to the tax exemption of municipal interest is the greatest it has been since the mid-1980’s, we do not expect any changes to occur until larger tax reform negotiations occur. We further believe that outstanding munipals will likely retain their tax-exempt status or, in other words, be grandfathered, but a two-tier market could arise.

With this uncertainty in this low interest rate environment, we are maintaining our disciplined research approach and are searching for investment-grade issues that provide additional yield, while eschewing additional duration risk. Our fixed income portfolios are, in general, defensively structured with relatively shorter average durations so as to reduce the price impact when interest rates eventually rise. We remain cautious and gradual when investing new cash. Finally, we are very cognizant of tax implications when making portfolio changes and, in most cases, are tending to avoid the realization of significant capital gains for tax-exempt bonds.

Gary Gildersleeve is a Partner and Fixed Income Portfolio Manager at Evercore Wealth Management. He can be contacted at gildersleeve@evercore.com.
For bond investors, the implications of Hurricane Sandy are significant. As weather events once considered extreme become relatively commonplace, it is critical to differentiate between the public entities that are investing for the long term and those focused on simply restoring the prior level of service and safeguards.

The final tally won’t be clear for some time, but initial estimates put it at more than the $23 billion caused by the September 11, 2001 attacks and in the ballpark of Hurricane Katrina, which cost $46 billion, based on the Insurance Information Institute, in 2011 dollars on insured loses. Hurricane Sandy could cost the property and casualty insurance industry between $10 billion and $20 billion, with total property damages reaching as much as $50 billion. Hurricane Sandy came hard on the heels of Hurricane Irene, which the Insurance Information Institute estimated to cost $4.3 billion.

There are many entities in the affected areas that will feel the financial impact from this hurricane. We focus here on some of the largest regional public utilities and transportation authorities on the East Coast, as well as government entities. These include:

• **New York Metropolitan Transportation Authority:**
  The MTA provides New York City subway and bus service, as well as rail service to Long Island and Westchester. The system suffered extensive damage, which will result in a loss of farebox revenue along with significant capital and operating costs. Due to previous concerns about an aging infrastructure, contentious labor issues and reliance on vulnerable state funding, Evercore Wealth Management has consistently limited its exposure to this transportation credit and has instead focused on the MTA dedicated tax bonds that are secured by petroleum, sales and franchise taxes, separate from the operations of the authority.

• **Triborough Bridge and Tunnel Authority:**
  The TBTA is an affiliate of the New York MTA and derives net revenues from seven bridges and two tunnels, including the recently flooded Brooklyn-Battery and Queens-Midtown tunnels. All of the facilities are very profitable, but the TBTA is required to transfer 90% of surplus revenues to the MTA after meeting its own operating and capital needs. The Queens-Midtown Tunnel is now operational and the Brooklyn-Battery Tunnel has resumed limited service, as there was little in the way of electrical equipment to repair. The MTA will obviously need additional revenues from all sources to cover its new operational burdens. However, debt service for the TBTA must be paid prior to transfers to the MTA, and this should offer continued protection for TBTA bondholders. We are confident in our continued exposure to the TBTA, which is substantial relative to other entities in the region.

• **Port Authority of New York/New Jersey:**
  The Authority’s primary source of revenues is from the operation of the three regional airports and the
tolls on the trans-Hudson River crossings. These enterprises are expected to continue supplying the Authority with a steady revenue stream, after some temporary closures. The primary cost to the Authority will be for the Port Authority Trans-Hudson, or PATH, rail system, which suffered extensive damage. The Authority may have to issue significant amounts of debt to cover repair costs in excess of federal aid and could impede progress in redeveloping the World Trade Center site. We will continue to hold this paper as the Port Authority has proven to be very resilient in maintaining its primary revenue streams while addressing its capital needs.

- **Long Island Power Authority:**
  LIPA provides electric distribution and transmission service to most of Nassau and Suffolk counties. The sub-stations on the south side of the island have been destroyed, and recovery is likely to be slow and costly. Our exposure to LIPA has been limited for some time, in part because the Authority is vulnerable to the state commandeering its rate-setting independence, and in part because it charges among the highest electric rates in the country.

- **Nassau and Suffolk Counties:**
  Both counties, although wealthy, have faced severely constrained operating budgets due to a variety of factors, including generous salary and benefit packages, contentious property assessment practices and difficult political situations that prevent a coordinated effort to address these problems. The damage to the two counties caused by Hurricane Sandy will further exacerbate their financial situations. As a result, Evercore Wealth Management has minimal exposure to these counties, apart from investments in Nassau County Interim Finance Authority debt. This is separately secured from the county general obligation debt and requires all local sales tax receipts collected by the state to be presented first to the authority for debt service payments.

- **New York City Municipal Water Finance Authority:**
  The Water Authority benefits from drawing the bulk of its water supply system from outside the New York City region. While the Authority has been dealing with an aging delivery system, there have been no significant water damage reports due to Sandy as of this writing, although the Authority also includes the sewer system treatment plants, which are still being evaluated. We remain active investors in this holding, encouraged by its excellent source of cheap water, autonomous rate-setting authority, and legal separation from the fiscal conditions of New York City. In short, New York City water is safe to drink, and to buy.

- **New York City General Obligation Debt and the State of New Jersey and New York General Obligation and Appropriation Debt:**
  While the brunt of the damage appears to directly affect the enterprise facilities listed above, New York City and the states of New York and New Jersey will inevitably feel the consequences as tax revenues initially decline. In the long term, however, all of these reconstruction efforts and the potential for federal monies coming to the region could prove a financial benefit to the overall revenue base, although specific sectors gain or lose depending upon the impact of the reconstruction efforts on their particular business. That is what happened in Louisiana as the state rebuilt facilities after Hurricane Katrina. We retain relatively significant
holdings in these issuers. We continue to closely monitor their outlooks.

- **New Jersey Coastal Counties:**
  Evercore Wealth Management has limited exposure to many of the coastal counties directly hit by the tidal surge, including Monmouth, Ocean, Atlantic and Cape May. As information becomes available for these and other New Jersey counties, particularly around the growing commercial areas within Hudson County, we will reassess our holdings. It should be noted though, that those areas hardest hit by Sandy will likely receive significant relief funds through FEMA.

  The increased frequency of what was considered extreme weather patterns has exposed the infrastructure of the New York metropolitan area. As Governor Cuomo put it: “The city is only a few feet above sea level. As soon as you breach the sides of Manhattan, you now have a whole infrastructure under that city that fills the subway system, the foundations for buildings and the World Trade Center site.” Issues that need much more extensive analysis include the following:

  - Will the management of these utility and transportation entities be satisfied with simply restoring service to previous levels? Or will they use this time to address these increasingly common weather patterns to further enhance the infrastructure of the region?
  - Some of the right questions are already being asked: Will states pick up the 12.5% of recovery costs that normally fall to localities? (They did after Hurricane Irene.) Will New York and New Jersey, both of which recently implemented local property tax caps, vote next year to allow the cost of disaster recovery to be exempted from the state’s property tax cap? How will local tax authorities assess a storm-ravaged home? And, with rebuilding costs easily in the billions of dollars, what is the outlook for other massive projects such as the $5 billion Tappan Zee Bridge?

  Our initial analysis leads us to believe in the full and timely repayment of our debt holdings. But we will be looking further out, to confirm that understanding and to identify long-term investments that address the consequences of this storm, and the ones that seem certain to follow. We continue to monitor all municipal bonds held at Evercore Wealth Management and will recommend sale if we believe it is warranted, as well as look for buying opportunities.
Checking the List

In the wake of Hurricanes Sandy and Irene – and ahead of the next once-in-a-lifetime storm – it’s worth reviewing homeowner, auto and flood insurance. Not all policies are created the same and any gaps should be addressed. In a nutshell, policies should include the following:

**Homeowner Insurance**
- Guaranteed rebuild of dwelling
- Replacement cost on contents
- Loss of use
- Back up of sewers and drains and sump pump failure
- Mechanical breakdown
- Trees and shrubs (enhanced coverage)
- Mold (increased limits)
- Scheduling of collectibles, such as jewelry, fine arts and wine
- Liability (most high net worth investors will want to be insured to maximum limits and to obtain additional limits through an umbrella policy)

**Automobile Insurance**
- Agreed value on the vehicle
- Towing and rental (increased limits)

**Flood Insurance**
Homeowner policies do not cover flood losses and FEMA considers financial status. Homeowners, both near the water and further back, should consider purchasing the following:
- A national flood insurance plan policy. Policies are offered in all flood zones. The maximum limit of coverage is $250,000 on the dwelling and $100,000 on contents. Coinsurance clauses can apply. Secondary homes have limited coverage: no coverage is provided for contents in a basement, for loss of use and for other structures, such as a swimming pool or garages. Debris removal is included in the dwelling limit.
- Excess flood, available in addition to a national flood plan policy.
- Flood extensions – some companies will offer enhancements to a basic flood policy.

Most high net worth homeowners will want to take advantage of large deductibles to reduce their premiums. And it’s worth checking that policies consider permanently installed generators, alarms and other loss prevention devices. Finally, all coverage should be reviewed annually. No one wants to discover limitations after the event.

Rhonda Linnett Graber, a personal insurance director of Bollinger, contributed this list. She can be contacted at rhonda@bollinger.com.
Alternative Assets
An Interview with Steven Romick
of FPA Crescent

Editor’s Note:
The FPA Crescent Fund seeks to provide long-term, equity-like returns with less risk than the stock market. Here, we interview Steven Romick, the manager of the $9.5 billion fund.

Q: FPA Crescent can invest in equities in pretty much any region, any style and any market cap. The fund has also made investments in leveraged loans, high-yield bond and distressed debt; it has shorted equities and currently has a position in a private REIT that owns farmland. With such a large investment universe, how do you determine what makes it into the portfolio?

A: We invest in what we believe are absolute, not relative, bargains. For a position to make it into the portfolio, it must be attractively priced on an absolute basis. Absolute cheapness can be determined in a couple of ways, depending on the characteristics of the business or investment. For a compounding investment, absolute value can be found in a situation that offers equity-like returns under reasonable worst-case scenarios. For a more trade-oriented investment, opportunities with a 3:1 upside/downside ratio, based on a conservative appraisal of fundamental value, are worthy of investment. For bulletproof credits, we will consider investments yielding Libor plus 700. For restructuring credits, we look for 15% plus yields to maturity or improved credit, and a valuation consistent with where we would purchase the “newco” equity if the credit were to undergo a restructuring.

We also take into consideration other positions and exposures in the portfolio to make sure we don’t become unduly exposed to one or two macro variables. In other words, the Crescent team looks for bad news and dislocation in the markets. In a weak housing market, we partnered with a third-party servicer and invested in sub-prime whole loans. With concerns surrounding central banks’ profligate printing, and the potential for unintended consequences such as high inflation, eroding of fiat currencies, and so on, we made an investment in farmland. When the market wasn’t taking into account the risk in the financial system midway through the last decade, we avoided owning any financial stocks. When the financial crisis of 2008-2009 hit, securities of financial companies were hit hard and we committed a lot of capital to the debt instruments of these businesses.

Q: How should investors measure the fund’s success?

A: The fund is admittedly hard to benchmark, given its broad charter. We consider risk to be the permanent impairment of capital. We have successfully accomplished this over the last two decades but not without some periods of
underperformance, which should be expected from a fund such as ours. In 1999 we were 59.2% behind the S&P 500 for two years, but by the end of 2002 we were 15.4% ahead for the five years. We look to protect capital first, prior to seeking to make a return on it.

Q: You currently have a relatively large position in cash, and have moved your cash position quite significantly, at times up to over 40% of the portfolio. What is the rationale for this allocation?

A: Cash is a residual of our investment process and not a top-down decision. Small cap stocks were dirt cheap in the late 1990s and we took advantage of the opportunity; as the result, our cash position was just 5%. In 2007 and in the beginning of 2008, we had approximately 31% in cash, believing that the market did not adequately understand the risks of the overindebted consumer, the housing bubble, and the undercapitalized balance sheets of many financial institutions.

Q: Currently, the fund’s allocation to bonds is much lower than it has typically been and the allocation to stocks much higher. What is driving that investment decision?

A: It is important to keep in mind that we do not operate with a target allocation to bonds or stocks. When we buy bonds, we generally buy corporate bonds, assuming credit risk, rather than interest rate risk. At this time, corporate bond spreads aren’t attractive and, worse, the starting yield is low. We just don’t feel that we are getting paid to play. As a result, our high yield/distressed positions are near an all-time low. When opportunities in the debt markets arise, we have historically increased our position size, and we expect to do so again.

Our allocation to stocks is a result of position-by-position analysis coupled with our unwillingness to have more than a certain portion of the portfolio in cash, given the concerns we currently have regarding inflation. In the future, we could imagine the equity exposure being larger or smaller, driven by the number and type of equity opportunities that we are identifying.

Q: What is your outlook for distressed debt and leverage loans? How does this exposure fit into the portfolio?

A: We are confident that there will be many credit cycles over the next 30 years. Currently, defaults and interest rates are quite low, and prices are quite high in the distressed debt and leverage loan market. Our exposure is therefore under 4%. When rates and defaults rise, we anticipate that we will be presented with a number of attractively priced opportunities in the high yield and leveraged loan market, and that our exposure will increase materially.

Q: How about that investment in farmland?

A: When we first purchased farmland a couple of years ago, we felt that it was an asset class that was not well understood and was under-owned institutionally. Of $1.3 trillion worth of farmland in the United States, less than $5 billion was invested institutionally. Compare that to timber, which had $250 billion value and $35 billion of institutional ownership. Farmland should benefit in the event of inflation and/or if fiat currencies erode in value. If neither occurs, farmland should still benefit if emerging markets continue to grow. The largest share of wallet for people coming from poverty is to improve diet. That means more protein, which requires more grain production globally.

Q: The fund has about $9.5 billion assets under management, after significant growth over the last few years. Is there a size that would constrain the fund’s investment style?

A: We intend to close well below our established level of capacity. Although it is possible to be too big, it is important to note that size also confers some advantages. Our size has enabled us to participate in farmland, for example, and in our sub-prime whole loan investments.

For further information on the FPA Crescent Fund, please contact Brian Pollak at brian.pollak@evercore.com.
Evercore Wealth Management Expands West Coast Presence with Acquisition of Mt. Eden Investment Advisors

Evercore Wealth Management announced on November 7 that it has entered into a definitive agreement to acquire Mt. Eden Investment Advisors, a San Francisco-based wealth management firm with $645 million in client assets.

The firm named three new partners, Keith McWilliams and Tim Barrett in San Francisco, and Michael O’Brien in Los Angeles. With these additions, Evercore Wealth Management will have seven partners serving high net worth individuals, families, and related institutions along the West Coast; Evercore Wealth Management will have a total of 25 partners across the United States.

To view the press release, please visit: www.evercorewealthmanagement.com.

Evercore Wealth Management Hosts Wise Women Event in NYC

Former Vermont Governor Madeleine Kunin joined Evercore Wealth Management clients on November 8, at the firm’s New York headquarters. Governor Kunin is among the few women to be elected governor in the United States; she also served as Deputy Secretary of Education and Ambassador to Switzerland. She is the author of several books, most recently *The New Feminist Agenda: Defining the Next Revolution for Women, Work, and Family*.

For information on this and future events, please contact Wendy Barasch at wendy.barasch@evercore.com.

Welcome Allan Kaplan

Evercore Wealth Management welcomed Wealth Advisor Allan Kaplan to the San Francisco office in October. Allan joined the firm from Merrill Lynch, where he served as an advisor to high net worth families, responsible for designing and implementing wealth management strategies and constructing investment portfolios.

He was previously the principal of Mainstream Investments, managing equity and debt portfolios for private investors. Prior to establishing Mainstream, Mr. Kaplan worked for six years at Goldman Sachs, where he provided strategic investment advice to individuals and family offices. He is a graduate of the University of California, Santa Cruz, and the University of California, Berkeley School of Law.

Allan can be contacted at allan.kaplan@evercore.com.

The Midwest Office Celebrates First-Year Anniversary with Clients

The Minneapolis-based Midwest headquarters of Evercore Wealth Management hosted a client reception on September 19 to mark their one-year anniversary with the firm. About 75 clients joined the team and CEO Jeff Maurer to mark the occasion on the new terrace at the Minneapolis Club.

To learn more about upcoming events in the Midwest, contact Martha Pomerantz at martha.pomerantz@evercore.com.
The Evercore Wealth Management standard is rooted in client relationships, shaped by our investment expertise and secured by the backing of a powerful, like-minded institution.

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