How should U.S. investors think now about investing in international equities? Although the financial crisis started in the United States, it quickly radiated out to the rest of the world and it has since exacted a higher toll on many markets than it did here. The U.S. stock market, which represents just under half the value of global equity markets, is valued at writing at about 14% below its peak in 2007, after recovering 102% from its March 2009 low. Over the same period, non-U.S. markets as a whole are still 36% below their 2007 peak after recovering only about 65% from 2009. Valuation levels in most international markets are at near historic lows relative to the United States.

That’s likely to remain the case for some time, at least in much of the developed world. The ongoing Euro crisis has been a major contributor to the underperformance of the European Union over the past three years while Japan’s economic future is bleak. In comparison to these economies, the slow U.S. recovery looks positively
Summer is the time to explore. Many of us have waved goodbye as our children and grandchildren head off to InterRail in Europe, to hike the Andes, to immerse themselves in Chinese languages – the possibilities seem endless. The world is their oyster and we at home can look forward to their return, knowing that they will have grown in confidence and maturity, with a greater appreciation of the opportunities and challenges ahead.

As investors, we too see a world of possibilities, both in the international markets and here in the United States. The risks are substantial, arguably greater now than at any point since the depths of the recession as the developed markets wrest with enormous – and still growing – budget imbalances. But these risks seem to us manageable, at the national level by governments who must realize the price of failure and at the personal level through sound diversification.

While Europe and, to a lesser extent, the slowdowns in Japan and China have dominated the news, many emerging economies are continuing to grow at a rapid clip and a number of U.S. companies have been very successful in orientating their businesses in that direction. At the same time, these companies are managing extraordinarily well through a stubbornly slow domestic recovery, a discipline that should stand them in good stead when recent gains in employment and manufacturing start to gather steam.

In this issue of Independent Thinking, our Chief Investment Officer John Apruzzese considers the respective merits of investing in large U.S. companies with significant overseas exposure and investing directly in foreign stocks and corporate bonds. Also here, Evercore Co-Chairman Pedro Aspe, writing at the onset of the Mexican elections, reflects on the challenges facing his country and considerable potential for reforms and new trade agreements that could drive a resurgence in the Mexican economy.

Regular readers will notice that we have restructured the order of our articles to better reflect our goals-based investment approach. We draw on our individual and collective areas of expertise to identify the best opportunities for each client across asset classes classified by their risk, return and liquidity characteristics. Our Efficient Architecture™ investment platform enables us to supplement our core capabilities with a range of non-proprietary investments, delivering transparent and cost-effective investment management that is in the best interest of our clients.

Here and in future issues you will find, in addition to the views of our CIO and our Evercore colleagues, articles addressing defensive assets, diversified market hedges, growth assets and alternatives, both liquid and illiquid. On the last subject, one of our external managers, AQR Capital in Greenwich, Connecticut, presents a compelling case here for achieving hedge fund-like diversification through liquid investments.

As always, please contact any one of us at Evercore Wealth Management to discuss the topics in this issue or with any other questions or comments you may have. For those of you heading off on your own adventures, we wish you an exciting journey. For all our clients and colleagues, we hope for a happy and healthy summer.
healthy. Parts of the developing world are far more attractive than the developed world and, at present, should account for at least half of a U.S.-domiciled investor’s international allocation, or about 15% of a total equity portfolio.

The aggregate statistics on the European markets are especially cheap for the obvious reason that European Union authorities have not yet demonstrated their ability to get ahead of the sovereign debt crisis. Small and mid-size companies are of course the most exposed to Europe’s internal woes but there are few bargains among the multinationals. When we compare global companies based in Europe with their U.S. counterparts (Kraft vs. Nestle, for instance, or BASF vs. Dow Chemical), there is no valuation differential. This tells us that the valuation differential between international and the U.S. markets is due solely to the domestically oriented stocks in their respective markets and is not a function of where a global firm happens to be headquartered.

Japan also continues to disappoint, as it appears unable to pull out of a 20-year deflationary spiral. Demographics, already a major concern, will be an even bigger problem for the country going forward. Its labor force continues to shrink and its population as a whole will begin decreasing in the near future. It is unclear whether a credit-based capitalistic economic system can survive when the population is declining. Japan will be the first country in history to test this theory.

China and other emerging markets are on a completely different cycle than the developed markets with different, sometimes diametrically opposed, issues. China has been trying to engineer a slowdown in the real estate sector for some time and is starting to gain traction. The risk here is that the authorities will go too far and cause economic growth to slow too rapidly. China also needs to transition from an economy overly dependent on investment to one with more consumption. The country’s stock market has performed poorly for a number of years even as its economy expanded dramatically. That could soon change: Equity valuations could get a lift, albeit from very low levels, as interest rates are reduced.

At the same time, some of the less heralded emerging countries, including the Philippines and Malaysia, are continuing to grow at a healthy clip. Closer to home, Mexico has an opportunity to compete effectively with China in manufactured exports if it implements necessary reforms, as Evercore Co-Chairman Pedro Aspe notes on page 5.

It is often argued that large U.S. companies have so much international exposure that it is not necessary for U.S.-domiciled investors to actually invest outside the country. It is true that about 40% of S&P 500 revenues come from outside the United States. It’s important to note, however, that these revenues are sourced predominantly in developed countries, notably in Europe, and don’t provide much proportional exposure to the real growth markets.

At Evercore Wealth Management, we have made a concerted effort in our domestic equity portfolio to invest in U.S. companies that have high exposure to emerging markets, an approach that has proven the most profitable way to benefit from China’s high growth rate over the past three years. We also see opportunities to build on this allocation by investing directly in emerging-market companies with especially cheap valuations and attractive dividend yields.

Another reason to own foreign stocks, as opposed to shares in globally oriented U.S. companies, is the possible short- to medium-term benefit from changing currency values. A U.S.-based investor will earn a higher return from a foreign stock if the U.S. dollar falls against the company’s home currency than from a U.S. company.
with significant exposure to the same country. Yes, the U.S. company will also benefit from higher profits translated into dollars, but not as much as a company domiciled and traded in that country because the dollar value of the stock gets a boost as well. Foreign equity exposure should favor countries with strong currencies, creating an effective hedge against a devaluation of the dollar. Many in the emerging markets are now the creditor nations to the debt-ridden developed countries so, on balance, the emerging currencies should be relatively strong.

Taking into account the international exposure of the companies in our U.S. equity portfolio, we believe a well-constructed total equity portfolio should have a 25% allocation to internationally based stocks. At least half of the international allocation should be to the faster growing and financially stable emerging markets. As part of our effort to create the most efficient portfolio possible in terms of fees and potential outperformance, we employ active management in developed markets and a passive approach to emerging markets.

Our direct exposure to stocks in developed international markets is through very active international equity managers with excellent long-term track records that are willing to concentrate their portfolios, avoiding the most troubled areas while picking stocks that can weather the storm and take advantage of opportunities. In the emerging markets, we especially like a fund that is weighted to the largest dividend payers and slants exposure to large, stable and well-managed companies. There are about 1,000 emerging market companies that pay dividends. This fund invests in the top third of these, ranking the stocks by yield and then weighting positions by aggregate dividends paid. The fund has consistently outperformed a simple market cap weighting of emerging markets since its inception in 2007.

At the end of the day, currency fluctuations will wash and superior business models will prevail, wherever they may be operating. There may be no place like home at present but there are great companies, big and small, in many markets. It’s as important as ever that U.S. investors not limit themselves exclusively to homegrown stocks, even when much of the world appears to be struggling.

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Two-thirds of global growth is expected to come from emerging countries over the next decade, as developed countries eliminate their fiscal deficits and reduce their debt levels. What’s wrong with that for Mexico? Eighty-eight percent of our external customers are from developed economies. We must extend our relations with emerging countries and diversify our exports. (See Figure 1.)

Mexico is likely to experience a slowdown in the second half of the year, as a result of global deceleration. Inflation should remain within the Mexican Central Bank’s target band (3.5% to 4%). Recent volatility has produced significant movements in exchange rates; as a result, there is an interesting correlation between

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**Figure 1: Contribution to global growth (%)**

![Figure 1: Contribution to global growth (%)](image)

Source: IMF, World Bank

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the Canadian dollar and the Mexican peso. Both tend to appreciate or depreciate in the same direction against the U.S. dollar. Both countries are commodity exporters and both are linked to the U.S. industrial cycle. (See Figures 2 & 3.)

International reserves in Mexico are at their highest level ($156 billion); year to date they have increased 10%, confirming the very outstanding job done by the Mexican Central Bank during this period of high volatility. (See Figure 4.)

Nevertheless, Mexico has to advance with concrete actions. We have an imminent need to sign a free trade agreement with Brazil and to negotiate our membership in the Trans-Pacific Partnership, or TPP. The TPP is the only serious and important trade negotiation underway today; the paralysis of the Doha Round and the continuing European financial crisis make it unrealistic to assume that, in the short- and medium-term, any other relevant trade negotiation front will prosper. It is
also the first multilateral negotiation that the United States is involved in since NAFTA and CAFTA, the lesser-known U.S. free trade agreement with Guatemala, Honduras, Salvador, Nicaragua and Costa Rica.

Mexico also has to relaunch economic reforms: tax, energy, labor, education, and science and technology. Regarding energy reform, in 2007 the Government enacted a new budget law that allowed oil surpluses to be used for fiscal stabilization purposes. Given the high oil prices in recent years, a balanced budget was possible. The challenge was to create funds for difficult years. Sadly, this is the second time in our history that we failed to exploit the oil boom to create a stabilization fund like those of Norway and Chile. We spent the additional income and more last year until we reached a fiscal deficit of 2.7% of GDP, even with oil prices above $100. With the price below $90 a barrel, the next government will have to apply significant cuts in current expenditure to reduce the deficit in 2013. Fiscal reform should be a priority. (See Figure 5.)

Brighter notes for the next two decades are the result of the 2010 census and the outlook for Mexico’s light manufacturing exports. The census confirms the reduction of fertility rates – only 1.7 children per family and falling – which means that during the next two decades the demographic dividend will be the highest to date, with both parents working, saving and consuming more. (See Figure 6.)

On the manufacturing front, this should be our decade. We have increased our competitiveness with lower unit labor costs, lower than even China, and we should displace that country gradually but significantly in the North American market and in others where we can negotiate our entry. It is important for investors to remember that Mexico exports a billion dollars of goods each and every day.

**Figure 6: Dependency Ratio**

\(\% \text{ of working-age population}\)

![Dependency Ratio Diagram]

Source: INEGI, Conapo
As the window starts to close on the enhanced current gift tax and generation-skipping transfer tax exemption amounts, many individuals and families feel caught in a bind, unsure whether to leap at the opportunity to save significant future transfer taxes or to hold fast to their assets, especially in current market conditions. However, there may be an alternative.

Spouse and Family Exempt Trusts, or SAFE trusts, can enable the spouses of donors to access the gifted funds, if needed. These trusts are designed to insulate all income and growth from federal estate tax for multiple generations, and may also protect the assets from divorce and other creditor claims, imprudent management and spending.

SAFE trusts are generally designed to benefit the grantor’s spouse and their common descendants for their health, education, maintenance and support. Family members, including the spouse, can serve as trustee, and can also be granted the power to name a new trustee. A husband can, for example, create a SAFE trust and name the couple’s children and the grantor’s wife as beneficiaries. At some later date, the wife can create another SAFE trust and name their children and her husband as the beneficiaries. These trusts can be drafted so that if either husband or wife needs the property, part or even all of the trust may be distributed back on a discretionary basis.

In short, by transferring both their remaining gift tax exemption and generation-skipping tax exemption into a SAFE trust, donors can take part or full advantage of the exemptions that are due to expire by the end of the year – and still sleep at night.

Some estate planners argue that gifting assets this way violates the doctrine of reciprocal trusts, which states that if two parties create identical trusts for each other, the trusts can be recharacterized as if each party created a trust for him or herself. (Of course, if one spouse has most of the assets, only one trust needs to be created.) In other words, at the death of one of the grantors, the trust created by the deceased grantor’s spouse will be recharacterized as a self-settled grantor trust and will be included in his or her estate for estate tax purposes.

It is possible, however, to draft a SAFE trust designed to avoid the pitfalls of the reciprocal trust doctrine. This could include naming different trustees, differentiating assets and dates for funding the trusts, and assigning dispositive provisions at the spouse’s death.

There are still a few more months to decide but time is getting tight. In each of the 2012 issues of Independent Thinking, we have encouraged investors to take advantage of the federal gift tax and generation-skipping tax exemptions that are due to change at the end of the year without a further act of Congress.

As discussed in previous issues, the 2010 Tax Act significantly increased the federal estate and gift tax exemption and lowered the transfer tax rate for 2011 and 2012. The $5,000,000 exemption (indexed for inflation to $5,120,000 for 2012) and the 35% tax rate provide a unique opportunity for individuals to transfer property out of their estates.

In 2013, the gift tax exemption will revert to $1,000,000; the generation-skipping tax exemption will be approximately $1.36 million; and the top tax rates will increase to a maximum of 55%.

In light of these pending changes, we recommend that individuals, families and related institutions evaluate their financial and estate plans and, where prudent, consider making gifts to take full advantage of this opportunity while protecting the donor or donors from financial reversals. SAFE trusts require careful drafting and planning, and the engagement of an experienced trust and estate attorney is imperative.

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Minnesota’s general obligation bonds maintain among the highest state ratings at Aa1/AA+. The credit rating reflects relatively low debt ratios, a fundamentally diverse economy and strong governance factors, evidenced by the executive’s unallotment authority and consensus revenue forecasting. Even with the recent government shutdown, the underlying strength of the state, combined with lower supply levels, has had little impact upon the state’s spread to AAA yields, a measure of the state’s relative health. These levels are not particularly attractive in the current market, where 10-year AAA yields are below 2%. However, the state’s debt can still provide relative stability from a credit perspective for an in-state investor.

By way of comparison, the state of Illinois, its ratings of A2/A, battles with California for the lowest state ratings in the country. Its outlook hinges upon implementing solutions to its largest credit challenges, including severe pension underfunding, chronic bill payment delays, and pressure from funding major Medicaid and education programs. However, the state’s sovereign revenue and spending powers, as well as the state legal provisions giving payment of general obligation debt service priority over other expenditures, provide investors comfort about receiving payment on a full and timely basis.

At Evercore Wealth Management, we recommend some out-of-state diversification that could compensate for the state tax benefit costs for Minnesota residents, where the top state income tax rate of 7.85% is among the highest in the nation. We also see other bond opportunities in specific sectors in Minnesota outside of state general obligation debt that can provide some diversity away from the state’s credit. These include the following:

Editor’s note: This is an extract from the recent Evercore Wealth Management perspectives piece Minnesota Budget Talks: 10,000 Political Takes. To view the full paper, please visit www.evercorewealthmanagement.com.
• **Minnesota Public Power Agencies:** The state has a number of public power agencies providing low-cost electricity to various groups of municipalities. We look for all-requirement contracts that require payment as long as power is supplied, along with take-or-pay agreements that remove project risk. Additional positive factors include competitive rates and diversity in generation resources. Environmental concerns regarding the potential for expensive upgrades to power resources need to be taken into consideration.

• **State Housing Agencies:** The housing market has experienced declines virtually all across the country, and Minnesota is no exception. However, we look for state housing agencies, such as Minnesota’s, that have strong agency oversight of the loan portfolio, which contributes to low loan delinquency statistics. In addition, many housing programs can take advantage of federal programs where the U.S. government provides loan guarantees.

• **Public Universities:** In most states, public universities in depressed economies have conflicting credit issues at work. On one hand, demand is strong, as students and families look to economize on the cost of a college education by attending a public rather than a private school. On the other hand, states have cut operating appropriations due to their own fiscal problems and the fact that public universities are one of the few state enterprises that have revenue-raising capabilities. We look for state commitment to funding, as well as the authority for state schools to increase tuition charges. Diversity of revenues away from just student fees and state appropriations, such as research grants and endowment income, is also a credit positive.

• **Private Colleges:** Minnesota has a number of private colleges and universities that are in the debt markets. These schools are grappling with how to make college affordable while covering expenses and dealing with increasing competition. We have selectively approved for purchase certain colleges that meet our high criteria, including strong endowment levels to operations and debt, high student quality, broad geographic demand and stable financial operations.

• **Minnesota State School District Program:** Participating school districts provide a general obligation pledge and must notify the state of a potential default within 15 business days prior to the debt service due date. The bonds are ultimately secured by the state’s pledge of an unlimited appropriation from its general fund. District repayment is either from state aid withholding or from a required special school district levy outside normal levy limits. The rating of the program is tied to the state rating and was downgraded when the state general obligation debt was downgraded.

• **Healthcare:** We are very cautious about the healthcare sector, as changes in federal funding and pressure on states to make cuts to their respective Medicaid programs have the potential to put additional financial pressure on these institutions. We prefer hospitals that have a dominant market share in their area and/or multiple areas, a strong clinical reputation, demonstrated fundraising ability and extensive recordkeeping capabilities in order to keep abreast with ever-changing regulations. The Mayo Clinic in Rochester, Minnesota, meets many of these criteria.

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Diversified Market Hedges
Saving the Euro

by Judy Moses

The Euro zone crisis poses immense risks to the stock and bond portfolios of individual investors. Flight to quality has brought capital to the United States, driving down bond yields to historic lows and strengthening the U.S. dollar. While most European equity markets are down year to date, the U.S. equity market is up. The dichotomy of current market prices between stocks and bonds represents risks to at least one asset class and perhaps to all assets of a balanced portfolio.

On the surface, the concept of the Euro zone made economic sense. One currency used by member countries would facilitate cross-border transactions. Open national borders would promote labor mobility. Policies that allowed for the free movement of goods, services, capital and people would lead to stable and superior economic growth. European policymakers used these concepts to sell their citizens on a flawed structure masked by the veil of a common currency.

It was under the guise of a common currency that sovereign debt yields of Euro zone countries falsely converged. No wonder Greece was so eager to join the Euro zone and adopt the Euro; membership enabled the country to borrow at the rates afforded to Germany. They used these borrowings to fund expansive public sector programs masking weak productivity and high labor costs. While Greeks enjoyed a higher standard of living for a period of time, they are now experiencing a fourth year of economic contraction. The government, which has turned over twice in the last two years, has been shut out of the capital markets and unemployment is shockingly high at over 20%. In short, Greece is stuck with currency that is too strong for its very weak economy.

On the other hand, Germany, until recently, greatly benefited from the ability to export to its fellow Euro zone members in the same currency. Not only did having a common currency immunize Germany from currency devaluations among its European trading partners, it also enabled German exporters to thrive. For Germans, using the Euro has enabled them to have a weaker currency than they would have using the Deutsche mark.

Today, European policymakers are desperately trying to save the Euro and restore the convergence of sovereign bond yields for two countries not yet shut out of the capital markets – Spain and Italy. Despite attempts such as the European Central Bank buying sovereign debt, yields between German bonds and Italian bonds have diverged even more this year, as German bond yields have fallen to new lows and Italian and Spanish yields have risen sharply. Austerity policies, designed to save bonds, hinder economic growth and cause equities to fall. Money printing to offset weak economic growth will hurt currency and bonds.

We do not know what shape or form the Euro zone and the Euro itself will ultimately take, but we do know that it is a highly unstable situation with policymakers trying ad hoc and partial solutions. We are seeing a policymakers’ crisis play out in the Euro zone. The problems are known – too much debt and too little growth – but the reaction of policymakers in real time has been slow and inadequate. They have tried money printing, austerity and promises of closer fiscal union. These aren’t working because they prevent markets from clearing and allow the continued misallocation of capital from strong to weak users.

The question is whether markets will clear naturally, which is to say quickly, or slowly and with years of no growth while government policy disperses loss across all constituents. Even after that, it could still end badly. It cannot end well when resources are continually misused.

The role of the Evercore Wealth Management Diversified Market Hedges Strategy is to insulate investment portfolios from government policy-related losses. With the risk of policy-induced losses high, an allocation to the Hedges’ strategy in a balanced portfolio should mitigate volatility and provide for better risk-adjusted returns over time.

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U.S. investors searching the world for growth opportunities won’t want to overlook those on this side of the fence. Domestic stocks, which have barely broken even over the past 12 years, may be poised for resurgence.

Consider the fundamentals. To invest in equities is to invest in companies. And U.S. corporate earnings are at record highs, thanks to enhanced productivity and restrained labor costs. Many investors are skeptical about the continuation of this trend, especially in light of the current global macroeconomic concerns coming from the Euro zone and China.

Yet the U.S. economy is still the largest and most dynamic in the world. Apple Computer, the poster child of American innovation, is a master at designing elegant products that seamlessly utilize its technology platform. The company is changing the way people across the globe live and work but its stock currently sells at only 11 times forward earnings, compared with 13 times for the S&P 500.

Valuations constitute another reason to be bullish on domestic equities. By historic standards, the S&P 500 is inexpensive, with a price-to-earnings ratio currently near 25-year lows. It looks even more inexpensive when examining the P/E multiple relative to interest rates. Evaluated by this metric, the market is trading at lows not seen for over 50 years. Furthermore, the dividend yield on the S&P is higher than that of a 10-year U.S. Treasury bond. Chevron Corp., for example, has a dividend yield of 3.6%, greater than that of its bonds and double that of a 10-year Treasury. It’s as if the appreciation potential of the company, one of the world’s largest energy concerns, is barely acknowledged by the markets.

Currency considerations are another factor. During the mid-2000s, international developed markets outperformed U.S. stocks by about 40% in dollar terms, as the Euro appreciated 60% over the same period. Hedge fund managers and institutional investors dumped dollars to own foreign currencies. In 2007, in what surely signaled the height of the frenzy, Brazilian model Gisele Bündchen declared that she would accept payment only in Euros. The markets have since reversed and, for U.S. investors, there is something to be said for dollar-based assets.

The Euro has depreciated 22% against the dollar and the S&P 500 has outperformed developed international equities by 49%, erasing the relative performance differential. Investors who plan to spend their proceeds in dollars will feel comforted that their exposure to the volatile world of currency markets is less with U.S. equities. Kentucky-based YUM! Brands derives over 70% of its profits overseas and over 50% of the total from the fast-growing emerging markets.

Finally, consider the timing. Individual investors have been net redeemers out of equity mutual funds for years now. At market peaks, individuals tend to throw money wildly at an asset class; at bottoms, investors shy away. The best approach is, of course, the opposite.

At Evercore Wealth Management, we believe that a balanced portfolio should include growth assets that represent a diversified range of industries and geographies. U.S. stocks, which now represent some of the best companies in the world at remarkably low valuations, are an important feature of that mix.

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Editor’s Note:

Ronen Israel is a principal at AQR Capital and a manager of the firm’s Multi-Strategy Alternative Fund. The fund seeks to deliver broad exposure to a diversified portfolio of hedge fund-like strategies while providing daily liquidity. Here he discusses the fund’s balanced, bottom-up approach to investing in a range of classic hedge fund categories and across the global stock, bond, commodity and currency markets.

Q: What role should alternative asset classes play in broadly diversified portfolios?
A: Investors who are already invested in traditional markets should consider adding alternative strategies to their portfolio as a way to increase returns and reduce risk through diversification. Alternative strategies can be defined in numerous ways, but here we are referring to the universe of liquid, relative-value strategies that provide potential diversification benefits relative to traditional markets. These alternatives have historically offered attractive risk-adjusted returns and, given that most of these strategies rely on an economically-intuitive source of return, we believe the prospective risk-adjusted returns are also attractive. When these strategies are properly built to be uncorrelated to traditional markets, they can both potentially increase the expected returns and lower the risk of a traditional portfolio.

Q: Why then are most hedge funds and funds-of-hedge-funds correlated to the broader markets?
A: Hedge fund strategies, especially relative-value strategies, are inherently capacity-constrained. To accommodate industry growth and keep up with return expectations, many managers have assumed passive, long exposure to traditional risk premiums, especially equities. In addition, many hedge funds have deviated from their initial focus on relative-value trades by adding strategies, say activist or distressed, that are less liquid and more difficult to hedge. Finally, in many parts of the industry, notably the fund-of-funds, managers may be passively long the markets just to keep up with other funds that are long. While we believe market exposure can be valuable, we don’t think investors should pay hedge fund fees to get it.

Q: How would you describe the investment approach of the AQR Multi-Strategy fund?
A: The fund seeks to provide exposure to a broad set of classic, liquid, relative-value strategies. The strategies in the fund are built from the bottom up to capture the core economic themes of each, using a systematic and transparent process. We maintain diversification through a disciplined approach that seeks to balance risks. Our multi-strategy framework means that investors can benefit from position and from fee and margin netting. Importantly, the fund is designed to have little correlation to traditional markets, thereby providing diversification to investors.
With its broad exposure to many hedge fund strategies and the transparent nature of the process by which we manage the strategies, we believe this fund is suitable as a core holding for investors looking to add alternatives. For investors with existing allocations to alternatives, we think this fund could be used as the core part of the portfolio, replacing some existing investments and complementing others.

Q: How do you define your investment universe?
A: We focus on liquid, relative-value strategies that don’t require a tremendous amount of leverage, are based on solid economic intuition and provide diversification benefits relative to traditional markets and other strategies in the portfolio. We believe that each of the strategies pursued has similar long-term efficacy, so we don’t have a significant, long-term tilt toward any one strategy. Instead, we seek to create a balanced strategic risk allocation, taking into account the volatility of returns, correlations, left-tail properties, leverage, cash usage and liquidity of each strategy. This is in direct contrast to much of the alternatives industry, which tends to overweight strategies that are likely to be overcapitalized, leading to portfolios that have higher risk and lower expected returns over time. By rebalancing back to balanced risk weights, our portfolio is naturally contrarian, and we will also tilt our strategic allocations modestly to reflect the conditional attractiveness of strategies.

Q: How about fees? Is your approach more cost effective for investors?
A: Our fund has a capped expense ratio of 1.98%. Traditionally, investors were only able to gain access to these types of strategies via hedge funds that typically charge 2% fixed plus 20% performance fees or via fund-of-funds, which charge an additional layer of fees. Importantly, our approach is designed to generate uncorrelated returns to equities, so our investors are not paying high fees for passive market exposure.

Q: A number of alternative mutual funds and ETF offerings aim to replicate the returns of the HFRI composite. What is the AQR approach?
A: Replication products seek to generate high correlations to the returns of a published hedge fund index, instead of trying to capture the insights of a specific hedge fund strategy. Different replicators take different approaches, but most use a backward-looking, top-down, statistical approach to estimate hedge funds’ aggregate exposures to a set of traditional asset classes and then mimic those exposures using futures contracts.

We believe replication suffers from a fundamental weakness that lies in its objective, namely delivering high correlation to hedge fund indices. Hedge fund indices tend to have a variety of biases, tend to reflect the weights of the most popular and crowded strategies and, most important, have too much exposure to traditional markets, which forces replication products to be long market-biased.

Our strategy uses a bottom-up, position-level approach to implement each theme and capture its underlying economic drivers of return. Diversification is key – as a result, the fund holds around 2,000 long and short positions across a variety of markets.

Q: Can you tell us a bit more about “hedge fund beta”? What does it mean for investors in hedge fund offerings?
A: We believe hedge fund strategies can be decomposed into three parts: exposure to traditional, common risk factors (traditional betas), exposure to well-known, dynamic sources of alternative returns (“hedge fund betas”) and true alpha, which is the part that cannot be explained by the first two and is derived from idiosyncratic and unique investment processes. While both “betas” can be captured in a disciplined manner, hedge fund betas are significantly more complex to implement than traditional betas. Yet, when implemented properly, hedge fund betas offer good long-term, risk-adjusted returns that are uncorrelated to traditional assets, and investors can now gain access to these returns via a diversified, liquid, transparent and cost-effective product like ours.

A lot of the “is it ‘alpha’ or is it ‘beta’?” debate comes down to semantics. Practically speaking, if you’re an investor who has no exposure to the types of hedge fund strategies we run in our fund, it is all alpha to you!

For further information on the AQR Multi-Strategy Alternative Fund, please contact Iain Silverthorne at silverthorne@evercore.com or any of the other partners at the firm.
Financial Advisor Ranks Evercore Wealth Management Among Top RIAs

Evercore Wealth Management was ranked among the top registered investment advisors in the United States by Financial Advisor magazine. The annual survey placed the firm 31st by assets under management of the 514 advisors named, and in the top third of those with assets of $1 billion or more. It also cited a 28% gain in assets for the year, making Evercore Wealth Management one of the fastest growing firms of its size.

Minneapolis Office Hosts Municipal Bond Event

The outlook for the Minnesota and other Midwest municipal bond markets was the topic at a June 2 lunch at the Minneapolis office of Evercore Wealth Management. Howard Cure, Director of Municipal Bond Research for the firm, addressed the gathering, following the publication of his report Minnesota Budget Talks: 10,000 Political Takes. To view the full report, please visit http://www.evercorewealthmanagement.com/news/perspectives.php. For further information on this and upcoming Minneapolis events, please contact Martha Pomerantz at martha.pomerantz@evercore.com.

Wise Women Welcomes Dominique Browning

More than 50 women joined Evercore Wealth Management and guest speaker Dominique Browning on May 24 for a lunch and discussion on overcoming major professional and personal setbacks. Browning, a writer and a founder of the non-profit organization Moms Clean Air Force, is the author of Slow Love: How I Lost My Job, Put on My Pajamas & Found Happiness and a former editor of House & Garden.

Wise Women was established by Evercore Wealth Management in 2011 to engage women in fulfilling their potential across the spectrum of wealth, family, career, community, and self. For information on this and future Wise Women events, please contact Wendy Barasch at wendy.barasch@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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