Low-risk investors are being fiscally repressed by the Central Bank. If CPI inflation runs at about 2% for the next 10 years, as the bond market currently expects, it will be nearly impossible to earn a positive real return by owning treasuries – inflation protected or not.

The yield on the three-month Treasury is just 0.1% while CPI inflation is running at about 3%; that’s a -2.9% return. Heading further out on the yield curve doesn’t help much. The five-year Treasury is yielding less than 1% and the five-year TIP is generating a real yield of -1.1%. The 10-year Treasury bond is yielding 1.9% and the 10-year TIP has a real yield of -0.3%. Even the 30-year Treasury only yields 3% and the 30-year TIP, while positive at least, returns only 0.75%.

Nor is it possible at the moment to earn a positive real return by venturing along the credit spectrum while staying within investment-grade ratings. At historic low yields of about 2% and 4%, respectively, intermediate-term, investment-grade municipal bonds and corporate bonds also don’t promise much in the way of positive real return after taxes. A bond investor also faces the possibility of significant short-term losses if long-term interest rates should start to increase.

(continued on page 3)
The old cliché, “sell in May and walk away,” is likely to be trotted out by the financial press quite a bit this season. But it has never made much sense for private investors who pay taxes. While there is some evidence that stocks perform better in the colder months, there is plenty more that market timing doesn’t pay in the long run. Private investors are best served by thoughtful, goals-based asset allocation and disciplined portfolio management.

Certainly, there is no obvious place to walk to. As we discuss in this issue of Independent Thinking, traditional defensive assets are now generating near negative returns. While many of our investors will want to maintain an allocation to treasuries, we see complementary opportunities to generate higher yields at lower risk across a range of alternative investments.

Here, our chief investment officer John Apruzzese takes a look at some of these nontraditional assets, including investments in credit and non-standard bank loans, as well as the total return bond fund managed by one of our external managers, Jeffrey Gundlach of DoubleLine Funds, who we interview in this issue. Equity portfolio manager Tim Evnin makes the case for focusing on total returns, no matter how great the temptation to chase dividends. And fixed income portfolio manager Gary Gildersleeve looks ahead, considering the prospects of specific bond holdings when rates eventually rise.

Diversification across geographies, as well as across asset classes, remains an important focus for all of the portfolio managers at Evercore Wealth Management. Roger Altman, the founder and chairman of Evercore, recently addressed some of our New York clients, noting that the global economy remains split between areas of low or even non-existent growth (the United States, Europe, Japan) and those with continued high growth, albeit at a slowing rate (China, Brazil, India). His analysis, published here, reinforces our view that it is vital for U.S.-domiciled investors to maintain exposure to developing countries, through shares in multinational companies and, as appropriate, through funds that invest directly in these markets. Roger also discusses the financial cliff that may occur at the end of the year as tax increases and the budget sequestration process begin without further legislative action.

We hope that you enjoy this issue of Independent Thinking, now expanded and redesigned. As we enter our fourth year, we feel more strongly than ever that we represent the new standard in wealth management, serving our clients first and always. Our continued growth supports that conviction and we are pleased this month to welcome two new colleagues to our New York office, Jonathan Bergner and Paulo Coelho.

Please feel free to contact any of the partners here at the firm to discuss the topics in this issue or with any other comments or questions you may have. We look forward to hearing from you.

Jeff Maurer
Chief Executive Officer
In short, the entire defensive allocation of a typical individual investment portfolio is returning anywhere from zero to -3% in real terms. This situation is unlikely to change any time soon as the Federal Reserve has committed to zero short-term interest rates for at least the next two years.

Most investors will nevertheless want to keep a portion of their investment portfolio in traditional low-risk assets. For many, that will enable them to sleep at night. And there is the chance that the United States will go the way of Japan, with a contracting economy and deflation that together would be expected to generate a positive real return on long-term, high-quality nominal fixed income. At Evercore Wealth Management, we do not believe the United States will follow Japan’s path for many reasons, including much better demographics and a more aggressive Central Bank, but the prospect cannot be ruled out.

Investors searching for income in excess of inflation, as well as those looking for growth, will want to consider other approaches. That need not mean taking a walk on the wild side of the risk spectrum, however. We believe there are significant opportunities now to mitigate risk through investments in nontraditional assets that, when properly diversified, provide more safety than traditional defensive investments with negative real yields.

Some of our most interesting investment opportunities at present involve providing credit to businesses in place of banks and the big financial firms.

Before we address alternative strategies, however, it is worth considering our views on why inflation, or at least inflation expectations, have not moved higher given the very loose monetary policy. Part of the answer is that the U.S. banking system is under extreme financial repression. Bank regulators are demanding very high risk-adjusted capital ratios, which force the banks to hold large amounts of negative real-return, fixed income investments. Not surprisingly, the banks and big financial firms have been shrinking their balance sheets and have a limited appetite for originating new loans that require high-capital allocations. The upshot is that money supply is not growing as rapidly as would be expected when the Federal Reserve floods the system with excess reserves.

It will fall on the non-bank financial system to provide the credit necessary to allow the economy to grow. Indeed, there are signs of this happening. Some of our most interesting investment opportunities at present involve providing credit to businesses in place of banks and the big financial firms. Middle market lending is the most direct example. We have, for example, invested client assets with a middle market lender that originates loans that help support private equity transactions. The investment is exposed to credit risk, which is controlled through diversification and excellent underwriting standards, but there is virtually no interest rate risk. All the loans are based on floating rates that are likely to only go up because they are based on a spread over three-month Libor that is currently 0.50%.

We also like investments in non-standard bank loans. These are syndicated loans that were originated by banks and subsequently sold off their balance sheets. The loans are not investment grade but they are all senior secured, floating-rate loans, which reduces the associated credit and interest rate risks, respectively.

Also attractive at present are alternative investments that could previously be accessed only through illiquid limited partnerships but are now becoming available in more liquid forms. In our opinion, these investments are positioned to provide positive real returns with limited correlation to the broader markets. One of the external managers on our efficient architecture investment platform, AQR, has recently developed a mutual fund with daily liquidity that combines all nine major alternative strategies into one fund with only one level of fees. Previously, these strategies could only be accessed by investing in fund-of-hedge funds with multiple levels of fees. This new fund is designed to have only half the level of volatility of the stock market and close to zero correlation to the stock and bond markets.

Further out on the risk spectrum is the stock market. Many risk-averse investors are wary of the stock market and its stomach-churning volatility of the past few years. But, in our view, stocks should be an important part of any investment portfolio. They are reasonably priced at present relative to their fundamentals, very cheap relative to bonds, and can serve as an inflation hedge over the long run. Stocks tend to not react well at first when inflation unexpectedly increases but eventually catch up in real terms. At the end of the day, stocks represent the ownership of productive assets; most businesses are able to re-price their goods and services to reflect the higher level of inflation.

International equity markets, especially the emerging markets, also offer interesting investment opportunities now, even for traditionally conservative investors. With high economic growth rates and low government debt, many of the emerging markets operate in very different investment environments than the developed markets, and their stocks produce very different returns, a potential asset in today’s marketplace.

Finally, it is important to note that we feel strongly that portfolios with long-term stock and bond exposures are likely to benefit from the inclusion of our Diversified Markets Hedges strategy, to buffer the portfolio against dramatic stock or bond market drops due to unprecedented government policies. In this strategy, we actively manage positions in gold, other commodities, foreign currencies, and various hedging derivatives in an attempt to protect portfolios, an approach that has served investors well since the strategy’s inception at the beginning of 2009.

These are difficult times for conservative investors but it is still possible to build and manage well-thought-out, risk-averse portfolios, even in this low-interest-rate environment. This is not your grandfather’s portfolio, that’s certain, but at current valuations, the greatest risk may be to plan for yields that just aren’t there.

John Apruzzese is the Chief Investment Officer of Evercore Wealth Management. He can be contacted at apruzzese@evercore.com.
The growing gap between the old world and the new world – the two-speed economy – remains the overarching global economic theme. The big emerging markets are growing at a much faster rate than the industrialized world.

Last year was a very weak year here in the United States. We grew at 1.7%. By the standards of economic recoveries since the 1930s, that’s the worst. Europe grew even less than we did, at 1.4%, and Japan shrank, by almost one percent. This year, regions representing over half of the world’s GDP are growing between 1.25% and 1.5%. Contrast that with the performance of the big three emerging markets, which together account for 24% of global GDP: China grew 9% last year; India just under 8%; Brazil 3%.

OUTLOOK FOR THE UNITED STATES

The most noteworthy characteristic of the U.S. economic recovery so far is how weak it is. Nearly three years after the trough, four headwinds impede recovery. These are: continued household deleveraging; retail gasoline prices; weak labor markets; and a still moribund housing market.

American households are still paying down debt, raising their savings, and spending less. Keep in mind that consumer spending in the United States accounts for 70% of our GDP.

It’s easy to forget how leveraged households were at the peak in 2007. Average household debt had reached 140% of its income. Housing values had soared, households felt wealthier, and they stepped up their borrowing and their spending. It never occurred to anyone that home prices could actually decline. And so, Americans were about as far out on the debt limb as they could get when the bottom of the market fell out. The average household then lost 20% of its net worth from peak to bottom.

Ever since, American households have been climbing back from that debt limb. Household debt is down to about 105% to 110% of income now. The long-term historical averages are about 90% and until they return to those levels, which may take another year or year and a half, consumer spending and borrowing will be likely to be less than we would normally have in a recovery.

A high proportion of the population is unemployed, underemployed, or has dropped out of the labor force – and that proportion of the population has, to put it mildly, limited spending power.

Gas is around $4 a gallon in much of the United States; in some places it’s higher. High oil prices carry a big geopolitical risk premium and, of course, lead in turn to higher gas prices. Like the labor market, the price of gas today is an inhibitor to economic growth.

As for housing, prices are down 33% from 2007 levels. Last quarter, they declined again. There are signs that the housing market is now beginning to stabilize. But, residential construction has usually led recoveries, and that obviously is not true here.

EUROPE

Compared to Europe, we look great. What is happening in the Eurozone represents the convergence of three big crises into one.

The first involves weaknesses that were in the original design of the Eurozone itself, an unprecedented experiment to adopt a single currency on behalf of 17 very disparate countries. The second is the lack of an enforcement mechanism to control fiscal deficits and sovereign debt levels. That led to noncompliance among most of the member countries. Finally, there was ambiguity of the mission of the new Central Bank, the ECB.
The United States reacted to the collapse of the credit markets in 2008-2009 in textbook fashion, by responding very quickly and with overwhelming force. The Federal Reserve provided $13 trillion of support to the credit markets in the United States through a whole series of facilities, all put in place over about six months. The long lens of history will view the way the Federal Reserve acted in 2008-2009 as the model for how to respond to a financial crisis. We had the stimulus, the TARP, the auto rescue, the stress tests; a very aggressive response. And now we are growing. It’s weak – but we are growing. Europe took none of those steps; no monetary stimulus, no fiscal stimulus, no bank recapitalizations. In their defense, they didn’t have the tools; no mechanism for broad stimulus across the countries, an undeveloped Central Bank, and so forth. But in any event, the United States acted forcefully and Europe acted passively, or didn’t act. And it’s not a surprise that the United States is in recovery and most of Europe is in recession.

The worst moments in the sovereign debt crisis are now behind Europe, however. The leadership of the Central Bank has changed and it is flexing its muscles, finally, harking back to how our Federal Reserve acted two, three years ago. But it is going to be a difficult two to three years during which Europe will be stagnant.

China

At one level, China continues to power forward in terms of growth – a rate of 7.5% is the envy of the world – and the short-to-medium growth outlook term looks good. But the investment and export-centered model that China has been following will run out of gas. China is facing the enormous structural challenge of revising that model, as well as some pretty serious demographic challenges. China’s population is considerably older than that of the United States.

Today, the investment share of GDP in China is extraordinarily high – about 50%. But that can’t continue indefinitely; the returns on more and more public housing, or more and more infrastructure of all types, are diminishing and will eventually be zero to negative. Exports are going to slow down, partly because the currency is appreciating, especially in real terms, and partly as a reflection of the weakness in the United States and Europe, which are important markets for China.

The Chinese authorities are keenly aware of this. They are also keenly aware of the challenge that they face in regard to the historic role the state has played in Chinese enterprises. Forty percent of Chinese GDP is represented by state-owned enterprises. All but three of the 42 Chinese companies in the global Fortune 500 are state-owned enterprises, as are 75 of the most valuable, publicly owned companies. The obvious question is: are these state-owned enterprises profitable? No one knows. But everybody suspects that the answer is no.

The Chinese authorities, who have managed very well so far, ultimately must convert from an investment- and export-driven model to a consumption- and domestic-driven model. That is a difficult pivot – especially since the investment share of GDP is so high and the consumption share has been falling. Turning this around is going to be very difficult.

U.S. Politics

November is a long, long way off in political terms. My view is that it is going to be a close election at the presidential level and at the House and Senate levels.

It's easy to forget how leveraged households were at the peak in 2007. Average household debt had reached 140% of its income. Housing values had soared, households felt wealthier, and they stepped up their borrowing and their spending.

But demographics are shifting in the United States. The number of college-educated men and women, and minorities, is growing and this is the new base of the Democratic Party. For this reason, states that a few years ago were seen as reliably red states – Nevada, New Mexico, Colorado, North Carolina, and Virginia – are now swing states.

It isn’t terribly likely that you will see a different dynamic in Washington when the dust settles, however. No party will have a substantial majority in either house. The partisanship is unlikely to dissipate.

I want to close on this note. A very rare legislative event will occur at the end of this year, with several giant events converging. All of the 2001 and 2003 tax cuts are going to expire. The payroll tax cut will expire. The so-called sequester, which was triggered by the failure of the Congressional Super Committee last fall, is going to begin. That’s $1.2 trillion of discretionary cuts. And the debt limit will probably have to be raised again around the beginning of the New Year.

This confluence provides the U.S. with a golden opportunity for fixing our deficit and debt problems. If all of the 2001 and 2003 tax cuts expired on schedule, for example, that would reopen negotiations over a grand fiscal bargain. We’ll see what actually happens, but 2013 is the key year on budget issues.
Investors frustrated by low yields in the fixed income markets are taking a look at equities – and for good reason: dividend yields for many stocks are outpacing those of bonds. That said, when investing in equities it is important to not focus on dividends at the expense of appreciation.

For most investors, equities are the primary component in their allocation to growth investments. The focus here should be on total return. It’s not that total return and dividends are mutually exclusive; dividends are often an important part of total return but they should be viewed in that context, as part of the whole. Whether a company pays dividends or reinvests to grow is one of the most important decisions its management can make – and a major determinant of an investment’s success.

Essentially, management has three choices: it can reinvest in the business; make acquisitions; or return the capital to shareholders. The latter it can do via a dividend or a share repurchase. Companies can of course pursue more than one of these options but the cash generated is finite and decisions need to be made. For long-term investors, with an outlook of at least three years, these decisions will have significant ramifications.

For some companies, the decision is simple, as the opportunities to reinvest or to make acquisitions that generate high rates of return are obvious and bigger than the cash available. For these, the hope is that management reinvests as much as it can, not returning any cash to shareholders. Shareholders will benefit as the capital invested in the business grows, generating higher returns in the future. In other situations, the opportunities to reinvest might not be as obvious or might not be large enough to absorb all of the cash that a business is generating. In these companies, it is critical that management realizes these limitations and considers all the potential uses of cash, including returning it to shareholders.

While returning excess cash to shareholders seems obvious, it is surprising how often management teams instead believe that growth, any growth, is good. This is clearly not the case. Growth that generates low returns on the capital needed to grow further is not a good use of cash. And, of course, growth and or acquisitions that generate negative returns and destroy capital permanently harm shareholders.

The recent Apple announcement was a very public example of a debate on capital allocation. Apple is one of those rare companies that is both growing very fast and generating excess cash. The cash had accumulated to a point that was obviously well more than needed for any conceivable business reason. A primary concern of shareholders was that the cash not be squandered, e.g. through poor acquisitions, and did not become a distraction to managing the business. In the end, the company’s decision seems sensible; the dividend is modest but a clear indication of current management’s willingness to return cash to shareholders. It also quiets, at least for now, the constant questioning in the marketplace about the company’s plans for its cash. As for the dividend itself, it could always be raised.

Autozone (AZO) is a great example of a management team focused on the importance of capital allocation and the ensuing rewards for shareholders. The company is in the stable but relatively slow growing automotive after-market parts business. The business generates very substantial cash, well in excess of what is needed for reinvestment. Management has been intent on returning the excess cash to shareholders and has done so via share repurchase rather than dividend. Over the past ten years, management has repurchased and retired well over half of the outstanding shares. This reduction in shares has helped turn 7% revenue growth into 15% plus compound earnings per share growth.
**Fixed Income: Preparing for Higher-Yielding Days**

by Gary Gildersleeve

Municipal bond yields reached historic lows earlier this year after a gradual, but dramatic, one-year decline. They have since moved higher for all but the shortest maturities, although the move upwards has been mitigated by limited net new supply.

We anticipate that the low-interest-rate environment will persist throughout 2012, but that rates could easily be higher by year end and much higher down the road. Any increase would be welcome news to yield-starved investors, but will impact the prices of existing bond holdings. With the average money market fund yielding less than 0.05%, what should bond investors focus on now?

**Buy Premium Bonds**

Most individual investors purchase municipal bonds for current income and safety of principal. They typically do not desire the lower cash flow provided by bonds purchased at a discount (below par), especially when rates are expected to trend higher. Bonds with higher coupons priced at a premium perform better in declining bond markets than lower coupon bonds with the same maturity due to their shorter durations. Premium bonds also maintain better marketability than lower coupon bonds priced at discount. The differential dates back to a provision in the Revenue Reconciliation Act of 1993 that states that the difference between the purchase price of a municipal bond purchased at a discount and its face value at maturity will be taxed as ordinary income. This causes lower coupon bonds to be even more volatile in a rising interest rate environment as individual investors require a greater yield and a still lower price to induce the purchase of a municipal market discount bond. As a result, the majority of new issues are brought to market with higher coupons selling at premium prices, while most outstanding municipal bonds are now priced at a premium as a result of the decline to historically low tax-exempt yields.

**Consider Callable Bonds**

Investors should also consider high-coupon, callable municipal bond sold at a premium and priced to a specific call date. Primarily intermediate and long maturity bonds priced to a short call, they are referred to as “kicker” bonds as the yield realized by the investor “kicks up” if the issuer does not redeem the bond at the time of the call. They also are called “cushion” bonds as the additional yield provided to maturity “cushions” a

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**A Word About Tax**

When considering the benefits of yield investing for clients with taxable portfolios, income tax rates are an important factor in the after-tax proceeds an investor ultimately receives.

While dividends have enjoyed very favorable federal income tax treatment as a result of the Bush tax cuts (generally 15% for qualified dividends), they will be subject to ordinary income taxes, with a top rate of 39.6%, beginning in 2013 if no new income tax legislation is enacted (see chart on page 14). Furthermore, for individuals with higher levels of investment income, there will also be a Medicare surcharge of 3.8% on that income.

From a federal income tax perspective, the tax rate on dividends may be as high as 43.4% for some taxpayers, almost triple the previous rate. While federal capital gains tax rates will increase to 20% from 15% and also be subject to the Medicare surcharge, this increase is much milder than that for qualified dividends.

Of course, for most investors, the most efficient after-tax results will continue to derive from holding on to equities for the long term and enjoying the tax-free compounding of returns.
bond’s price compared to that of a noncallable bond in a rising rate environment. An added benefit is that a “kicker” or “cushion” may be pre-refunded to the call date, which would increase the credit quality and price of the given security. The yield to call is normally higher than that of a bond of comparable coupon and quality that matures at the same time as the call, while the yield to maturity is also higher than for a noncallable issue of the same issuer.

**Don’t Rush**

Money market fund yields may average less than 0.05% and money market instruments provide only another 0.10% to 0.15% more, but rushing to invest, especially in short maturity bonds (one to five years), may be counterproductive. Most high-quality investments maturing within two years yield less than 0.60%. That translates into only a 0.05% return per month. Waiting a month or longer for more attractive investments can more than compensate for temporarily accepting low money market rates.

**California**

by Howard Cure

Editor’s note: The following is extracted from the recent Evercore Wealth Management report “California at the Crossroads.” To view the full report, please visit www.evercorewealthmanagement.com or contact Howard Cure at cure@evercore.com.

Despite the state’s recent improved outlook revision, California still has, by far and away, the most volatile rating history of any state with over 30 changes in ratings and outlooks, up and down, since 1980. This rating schizophrenia can be attributed to the extreme pluses and minuses of the state.

The plus side includes its economic diversity, still excellent and massive public university system, a dynamic venture capital financing system, and a dominant position in one of the most important global industries – technology. On the minus side is the state’s overall dependence on a volatile revenue source – personal income tax – coupled with an historic lack of discipline to properly budget for the unpredictable nature of this source.

The proposition system also hampers California from structurally balancing its budget by closing off many avenues of financial flexibility that are commonplace in other states. We recognize California’s recent positive changes in its political system, ironically through the proposition system, including simple majority budget approval, independent redistricting commission, and open primaries. However, the state still has difficult decisions to address before it can achieve long-term structural balance while maneuvering through the embedded political system. The question of whether voters approve an income/sales tax increase this November will also have a bearing on the state’s structural financial balance. Ballot-box budgeting is California’s challenge and the reason we expect a continuation of the volatile rating history.

**California vs. State General Obligation Spread at 15-Year Maturity**

![Graph showing California vs. State General Obligation Spread at 15-Year Maturity](image)

**Evercore Wealth Management Portfolios**

We remain very selective in our investments and are primarily purchasing premium-priced bond issues that will maintain their marketability should rates rise. In-depth credit research enables us to identify opportunities that provide additional yield instead of increasing duration. This should further mitigate the impact on total return should rates rise. We have found investment opportunities in A- to Aa-rated intermediate sized issuers that represent value, as well as callable bonds, which provide higher yields and less price volatility than noncallable bonds when rates increase. We continue to emphasize revenue bonds, especially essential purpose revenue and dedicated tax issues, with dependable revenue streams that are in monopolistic positions.

Gary Gildersleeve is a Partner and Fixed Income Portfolio Manager at Evercore Wealth Management. He can be contacted at gildersleeve@evercore.com.
Proposed Changes to Money Market Funds

by Sandy Panetta

Important changes proposed by the SEC could be on the horizon for money market funds. These changes, if implemented, could have significant repercussions for money market investors. At Evercore Wealth Management, we are keeping a watchful eye on these developments. Our sweep fund holdings are limited to Treasury-only money funds, which will likely be exempt from these changes.

The proposed changes would build on those adopted in 2010 in response to the events of 2008, which included the historic “breaking the buck” of the Reserve Primary Fund in September of that year, when net asset value fell below $1 per share. These included more conservative investment parameters related to credit quality, maturity limitations, and liquidity requirements. Among the most significant of these new proposals are as follows:

Imposition of a Minimum Capital Requirement: Many money fund investors operate under the assumption that for every $1 invested in a money market fund, they will be able to take out $1 at any time – and they operate under the assumption that the fund sponsor will make investors whole in the event of a problem. What investors may not realize is that fund sponsors do not have a legal obligation to redeem their shares at $1 and, even if it is in the sponsor’s best business interest to do so, the sponsor may lack adequate capital to rescue the fund. To address this issue, funds would have to set aside capital to absorb future investment losses should they occur. This could be achieved by an assessment on fund shareholders, which would lower already paltry returns, or by requiring fund sponsors to provide the cash, which could force smaller sponsors out of the business;

Redemption Restrictions: Rather than having the ability to redeem all shares at $1 per share on demand, investors would have immediate access to 95% of their shares (although the exact amount has not been finalized) and would receive the balance after 30 days. Given investor expectations of immediate access to all of their cash, this provision could sharply diminish the appeal of money market funds;

Floating Net Asset Value: Under current regulations, if funds are in compliance with SEC rules governing credit ratings, diversification, and maturity of investments, they are permitted to value each share at $1, regardless of the true market value and credit quality of the fund’s investments. While a floating net asset value would eliminate the sacrosanct expectation of $1 in/$1 out, it would increase transparency regarding the credit quality/risk of fund investments, as well as the ability to detect shifts in credit quality of such investments over time. In addition, a floating net asset value could make it easier for investors to compare credit quality across funds.

The state still has difficult decisions to address before it can achieve long-term structural balance while maneuvering through the imbedded political system.

We are more optimistic about the long-term fiscal situation in California, although the proposition system could still create further fiscal uncertainty in the run up to the November election. Despite the state’s high income tax burden, we have recommended a geographic diversification strategy that is intended to recoup the tax advantage lost, as well as provide additional credit security in case a recession occurs that has a disproportionate impact on California. When employed, this percentage usually ranges from 10% to 25% of the municipal bond portfolio. Within the California portfolio, we see a number of attractive investment opportunities.

Howard Cure is the Director of Municipal Bond Research at Evercore Wealth Management. He can be contacted at cure@evercore.com.
The last four years have been characterized from an investment standpoint by significant and persistent governmental intervention in the capital markets and unusually low economic growth. The two are not unrelated.

Within this largely static economic pie, government efforts to support one asset class have come at the expense of others. Money printing, for example, helped equities but devalued currency. Austerity, conversely, helped European bonds but hindered growth and equity returns.

Our investment approach seeks to insulate investment assets from policy-related losses. We seek profit in investment risks which cannot be diversified away with traditional portfolio allocations of cash, bonds, and stocks.

There is an incongruity to the major asset classes in the United States right now. Bonds sell at all time high prices and record low yields. Stocks sell at average multiples, but at peak earnings and peak margins. Both asset classes embed expectations of future supportive policy, but at these prices policy cannot be mutually beneficial. Further, complications of already-enacted policy pose risk to the value of both asset classes, as well as the dollar.

Reversing the extreme policies of the past few years may be as destabilizing to capital as perpetuating them. Elected fiscal bodies seem incapable of imposing fiscal discipline until the last possible moment. This inability to limit government spending is not unique to southern Europe. U.S. fiscal policy is producing a fourth year of trillion dollar deficits, a scenario even the most shameless Keynesian would not have forecast in 2009.

Fiscal authorities could plausibly be avoiding budget contractions for reasons related to differences in economic theory but, obviously, the answer is much simpler. Governments that propose austerity lose elections. Greece, Spain, Italy, Portugal, and Ireland have all had governments fall during the debt crisis. Nearly half of the world’s GDP comes from countries facing potential leadership change in the next year. Debts and deficits can be expected to continue, with consequences for economic growth.

Paul Volker is credited with reversing the monetary excesses of the 1970s, but the immediate consequence was a sharp, early 1980s recession. In the last two years, the Federal Reserve suspended monetary intervention twice – once in the spring of 2010 and once in the summer of 2011. Both pauses were followed by sharp stock market corrections. Thus, reversing severe monetary expansion is similarly challenging.

Today, stocks and bonds are priced with low-risk premiums against policy and the economic consequences of extreme fiscal and monetary action are just beginning. The likelihood that stocks and bonds decline together seems much greater given this starting point than the likelihood that they rise together.

The Diversified Market Hedges strategy is an attempt to counter policy complications and the risks they pose to investment portfolios. It is designed for use alongside a traditional portfolio allowing stock, bond, and currency investments to achieve their traditional objectives without leaving investment portfolios unguarded from clear and present dangers created by governmental policy intervention in the capital markets.

Diversified Market Hedges: Clear and Present Dangers

by John McDermott and Judy Moses

Finally, it is important to note that even if some (or all) of these proposals are adopted, the lead time for implementation could be long. In the interim, we will continue to monitor these and any related proposals and evaluate their potential impact on our clients’ portfolios.

Sandy Panetta is a Partner and Fixed Income Portfolio Manager at Evercore Wealth Management. She can be reached at panetta@evercore.com.

At Evercore Wealth Management, we utilize BlackRock and Federated money market funds as sweep vehicles for client accounts. We monitor these funds via quarterly conference calls with fund managers in addition to reviews of the prospectus and holdings reports of all the funds that are held at the firm. Given the extremely low-interest-rate environment and minimal additional yield offered by prime and municipal funds, our sweep account investments have been confined to Treasury funds since mid-2011.

Sandy Panetta is a Partner and Fixed Income Portfolio Manager at Evercore Wealth Management. She can be reached at panetta@evercore.com.

Core Capabilities

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Our investment approach seeks to insulate investment assets from policy-related losses. We seek profit in investment risks which cannot be diversified away with traditional portfolio allocations of cash, bonds, and stocks.
Federal Estate, Gift, Generation Skipping Tax Landscape

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<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>Maximum 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>Maximum 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 (indexed no portability)</td>
<td>$1,360,000 (indexed no portability)</td>
</tr>
<tr>
<td><strong>Maximum GST Tax Rate</strong></td>
<td>35%</td>
<td>55%</td>
</tr>
</tbody>
</table>

- In 2013, without a further act of Congress, the federal estate, GST, and gift tax rates, rules and exemptions will return to those in effect prior to the enactment of EGTRRA.
- Note the annual exclusion amounts are indexed and increased in increments of $1,000. The annual exclusion amounts in 2013 are estimated.
- The 2013 GST exemption will be $1,360,000 subject to further inflation adjustment.
- This chart does not include any possible state estate tax rates, rules, or exemptions.

Federal Income Tax Landscape

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top Federal Marginal Tax Rate for Ordinary Income</strong></td>
<td>35%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Long Term Capital Gains (assets held &gt;1 year)</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>- Top Bracket</td>
<td></td>
<td></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)</td>
<td>35%</td>
<td>39.6%</td>
</tr>
<tr>
<td>- Top bracket</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qualified Dividend Income Tax Rate - Top Bracket</td>
<td>15%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Medicaid 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 1st, 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.

Chris Zander is a Partner and the National Head of Strategic Wealth Planning at Evercore Wealth Management. He can be contacted at zander@evercore.com.
Jeffrey Gundlach is the Chief Executive Officer and Chief Investment Officer of DoubleLine Funds. Here he discusses his outlook for the DoubleLine Total Return Bond Fund, DBLTX, which invests in debt securities, notably in mortgage-backed securities guaranteed by the U.S. government and related institutions. The fund returned 2.96% in the first quarter of 2012 and 9.50% since its inception in 2008.

Q: The DoubleLine Total Return Fund focuses almost exclusively on residential mortgage-backed securities, or MBS. How does this asset class compare with other taxable fixed income securities?

A: There are two ways to think about this question. First, how does the agency-guaranteed MBS sleeve of the Barclays U.S. Aggregate Bond Index compare to the other sleeves of the Index over time? The answer is: “favorably.” An analysis of the multi-decade data set shows that the agency MBS sleeve of the Index has had persistently superior risk-adjusted returns compared to the other sleeves making up the Index. Second, how does the non-guaranteed, default-exposed MBS market compare with other credit opportunities today? The answer is: “favorably.” The prospective returns available in the credit MBS market today analyzed to a poor future outcome are generally superior to those available in the corporate credit market analyzed to a good outcome.

Q: How would you describe your investment approach?

A: The DoubleLine investment approach is to allocate assets among market opportunities in a way that tilts the odds of success in favor of our portfolios. This means focusing on investments for purchase that can be analyzed to offer a positively and asymmetrically skewed risk/reward trade-off.

Q: What are some examples of current investments?

A: In fixed income, DoubleLine currently has a significant investment program integrating the government-guaranteed MBS securities market with the non-guaranteed MBS market. The opportunities relative to the risks of this program have been rewarding and continue to be quite compelling. In diversified fixed income portfolios, DoubleLine favors dollar-denominated securities, total avoidance of counterparty risk, mortgage credit risk over corporate credit risk, and moderate weightings in emerging market debt.

Q: What are your expectations for home prices and inflation rates? How is the portfolio positioned accordingly?

A: Since we invest in securities affected by home prices and inflation rates, our philosophy is to hope for the best but prepare for the worst. The positioning of portfolios is based upon a broad range of future outcomes rather than one certain expectation of economic variables. I expect home prices to remain weak and income growth (true inflation) to remain low. I hope I am wrong.
Q: What are the associated risks for investors in the portfolio? How, for example, would stagflation or declining house prices affect returns?

A: Investors should think of DBLTX as a combination government bond portfolio/credit bond portfolio. The risks to the portfolio associated with stagflation or declining house prices are no different than the risks associated with any other bond portfolio diversifying between government debt and private debt. Our view is that declining home prices are fully priced into non-agency guaranteed MBS, while the consequences of falling home prices are not figured into the prices of other asset classes.

Q: What are your current expectations for the portfolio’s cash yield, assuming stable prices?

A: I expect DBLTX to offer a dividend cash yield at a significant premium to its peer group for the foreseeable future.

Q: The fund has grown significantly since its inception. What are your expectations for further growth and how might this affect your investment approach?

A: We expect asset growth to remain strong given the attractiveness of the risk/return profile of the Total Return Strategy. But DoubleLine is very sensitive to optimizing offerings to investors and not “super-sizing” a fund just because there might be demand. Recently, we closed our highly successful RiverNorth/DoubleLine Strategic Income Fund. It was the right thing to do based upon strategy constraints and it shows that we are sensitive to capacity limits. We will apply this same philosophy across our suite of products.
Evercore Wealth Management Featured in Family Wealth Report


Welcome Jonathan Bergner, Paulo Coelho

Jonathan Bergner and Paulo Coelho both joined Evercore Wealth Management this month, from U.S. Trust and Convergent Wealth Advisors, respectively. Both are based in our New York office. Jonathan, a Portfolio Manager, can be contacted at jonathan.bergner@evercore.com; Paulo, a Wealth Advisor, can be contacted at paulo.coelho@evercore.com.

Fixed Income Team Featured at IPI Gathering in San Francisco

The Institute for Private Investors featured Gary Gildersleeve, a Partner and Portfolio Manager, and Howard Cure, Director of Municipal Bond Research, at an event in San Francisco on April 19, and was followed by a reception at the Evercore Wealth Management office. Please contact Iain Silverthorne at silverthorne@evercore.com for details.

Minneapolis Office Hosts Estate Planning Event

The Midwest regional offices of Evercore Wealth Management hosted two client events on April 24 featuring Chris Zander, a Partner and the National Head of Strategic Wealth Planning. For information on these and future events, please 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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