To a rock climber, a preoccupation with the nooks and crannies of the immediate cliff face is understandable. But a mountaineer keeps in mind a higher goal.

Investors who focus exclusively on the relative performance of the individual components of their portfolio risk losing sight of the bigger picture. While it’s important to set standards by which to measure investment performance, there are often a number of applicable traditional benchmarks in any portfolio — and rarely a single one that enables investors to evaluate the success of the portfolio as a whole.

Benchmark hugging can also compromise investment returns. Two Yale professors demonstrated this a few years ago when they found that the level of active management predicts performance, with active managers outperforming those who stayed close to their benchmarks.* The experiences of investors in domestic stocks through the technology boom and bust a decade ago and the subsequent and very similar dramas in the financial sectors illustrated in the chart on page 3 certainly bear this out.

As these industries came in turn to account for significant proportions of the S&P 500 Index, investors who had thought themselves diversified instead discovered considerable holes in their total portfolios, forcing them to recalibrate their circumstances and aspirations (see Tim Evnin’s article on page 6). In 2011, another version of this scenario played out, when equity investors pegged to a global benchmark significantly underperformed the U.S. market.

We see plenty of evidence that the same theory applies to fixed income and alternative strategies. Consider municipal bond securities that are index-ineligible — an area of opportunity that most investors overlook. The benchmark used by many investors, the Barclays Capital Short-Intermediate Managed Money Index, is restricted to bonds with very specific criteria, including size (individual bonds must have a par value).
2012 is shaping up to be an interesting year. Private investors have become accustomed, if not resigned, to volatility and are braced for further – and possibly frequent – crises in the markets. Still unfolding events in Europe, the pending slowdown in China, and the prospect of a closely fought presidential election here in the United States all signal considerable turbulence in the coming months, even as domestic business conditions continue to improve. The right response is, as it was in far more difficult times, to keep calm and carry on. For us, that means staying focused on individual client goals and measuring our performance accordingly. In this issue of Independent Thinking, we take a look at benchmarks. Or, as Iain Silverthorne, Tim Evin and Brian Pollak put it, we look beyond benchmarks, charting our progress against traditional indices but never allowing their constraints to limit our allocation strategies or govern our approach to investment management. We measure our success by many standards, including all applicable industry benchmarks. But for us, meeting our clients’ goals is the standard that ultimately matters. Also in this issue, John Apruzzese lays out the firm’s current investment outlook, while George Ackert of Evercore considers specific challenges and opportunities for investors in unionized transport companies. We also take a look at New York City debt, small cap stocks and some topical estate-planning issues. By both traditional and client-centric benchmarks, 2011 was a good year for Evercore Wealth Management. Assets under management grew almost 30% from the previous year and we are now managing $3.2 billion. At the same time, we expanded our presence to the Midwest, joining forces with an experienced team that shares our values and broadens our capabilities. All told, we’ve done a good job across the firm in serving our clients, managing their assets in challenging markets to preserve and grow their wealth. Those of us who have worked together for more than 20 years are, along with our new colleagues across the United States, very grateful for the continued success of the firm and for the confidence of our clients and support of our colleagues at Evercore. We are confident that we will continue to build our firm, establishing a new standard in wealth management. As always, please feel free to contact any of us at Evercore Wealth Management, in our New York, Minneapolis and San Francisco offices. We welcome your views and look forward to continuing our conversation through what promises to be an eventful and exciting year.

By both traditional and client-centric benchmarks, 2011 was a good year for Evercore Wealth Management.

Jeff Maurer
Chief Executive Officer

Disclosures

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of at least $7 million and must be part of a deal of at least $75 million) and sector (it does not include airline, healthcare or housing bonds).

While the index is a useful measurement in many ways, its parameters are pretty narrow. Investors can generate greater yield without sacrificing credit quality through research-driven investments from deals that may be too small to make the index or from bonds in excluded sectors.

Bonds in both these categories can provide in excess of 100 additional basis points over the Municipal Market AAA scale.

Also outside the pale for many U.S. investors are bonds denominated in foreign currencies. That's because most foreign bond mandates and the major foreign bond indices focus on either international developed markets or emerging market currencies. Investors who see opportunities in both assets have no single benchmark to track their combined holdings and return streams. But that shouldn't preclude owning them; investing in the combination paid off handsomely for dollar-denominated investors in 2009 and 2010.

At Evercore Wealth Management we strive to set and beat applicable industry benchmarks across all of our assets classes. But in managing customized individual portfolios we find that investing beyond the benchmarks and away from the consensus thinking that often comes with benchmark hugging can help generate superior returns.

The firm’s Diversified Market Hedges strategy, or dMH, is a case in point. We have a stated benchmark, the Barclays U.S. TIPS Index, but in practice we measure our performance against a multitude of different asset classes. As the strategy is designed to protect balanced portfolios by rising in value when other, broadly owned asset classes underperform, it has very little in common with any likely benchmark, including the TIPS Index (indeed, the strategy has generally invested very little in the
TIPS sector). Since inception in January of 2009, DMH, as illustrated in the chart on page 3, has outstripped not just the Barclays U.S. TIPS Index, but also a range of bond indices and a balanced portfolio of 55% stocks and 45% municipal bonds.

We aren’t the only managers who see the world differently. Our efficient architecture™ investment platform allows us to selectively access and invest in outside managers who we believe also seek to go beyond the benchmarks.

The DoubleLine Total Return Fund (DBLTX), for example, nominally uses the Barclays U.S. Aggregate Index as its benchmark, an index that essentially covers the entire U.S. taxable bond universe. But DBLTX takes a far narrower view, investing primarily in mortgage-backed securities and in bonds that adhere to a very specific strategy. The manager has consistently outperformed his index and is one of the top bond managers of any stripe over the past 15 years. In 2011, when many active bond fund managers, including some of the best known, struggled mightily, DBLTX generated a more than 9.5% total return, well outstripping the Barclays U.S. Aggregate Index.

More importantly still, investing beyond benchmarks enables us to meet specific client goals. For example, an individual may have a specific overarching goal in mind, such as to maintain purchasing power of their assets while achieving a particular spending rate. Our approach could be to back into the required total return calculation, including not only the spending amount (either in dollars or in percentage terms), but also fees, taxes and inflation expectations.

The result, while not precise given the volatility inherent in capital markets, serves as a guidepost when structuring the portfolio to confirm that the asset allocation (and its components) actually has an opportunity to achieve that result over a longer-term time period. By focusing on the objective, this new benchmark standard, which is really created and customized for the need of an individual, serves as a reference point to help avoid increasing risk when times are good and becoming too risk adverse during market troughs.

We consider it an important part of our job as investment advisors to determine the appropriate benchmark or benchmarks for each client’s overall portfolio. But, at the end of the day, the only standard that really matters to our clients is whether we helped them achieve what they wanted, in the context of their unique circumstances and attitudes to risk. For us, this is the higher goal.

* “How Active is Your Fund Manager? A New Measure that Predicts Performance” by Martin Cremers and Antti Petajisto, Yale School of Management 2007

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package worth $250k) that is a multiple of their next best alternative (about $80k).

This is why every major airline bankruptcy emergence is accompanied by 30% pay cuts for the pilots, as well as the elimination of defined benefits and bad work rules. There is no exception to this rule as the histories of United, U.S. Airways, Delta and Northwest testify. The pilots are not the only characters here; agreements with the other airline unions, including flight attendants, ramp workers and mechanics, take the same trajectory.

At this juncture, another young airline starts up, purchases new and efficient planes and hires young flight attendants and cheap pilots. Its costs are 20% lower and, in a business with 5% profit margins, it can operate at a 10% profit margin and push the old airline into a 10% loss on competitive routes. This is how Southwest, Airtran and JetBlue helped drive Delta, AMR, United and U.S. Airways into bankruptcy. Sadly, other than the crafty Alaska Airlines, which bucked the trend by lowering its costs and avoided significant direct competition by aligning itself with both AMR and Delta, no legacy airlines have avoided Chapter 11.

The general rule in a commoditized business is that low-cost providers win. Airlines like to say that they offer a differentiated product (with LiveTV, “great” service, a pillow or even a hot cookie in Milwaukee on the old Midwest Airlines), but fliers prove otherwise by continually choosing flights based on price, availability and little else.

History may repeat itself at the hitherto untouchable Southwest. Southwest’s 12-year pilots have the highest wages in the domestic industry, earning $212 an hour, compared with about $165 an hour for the legacy majors like Delta and American. The airline’s innovative business model (low fares, convenient, reliable no-frills service) is the stuff of legends and the airline continues to improve productivity, which offsets some of the salary rise. Southwest’s costs are still 20% lower than most of the industry. But the cost gap between Southwest and the legacy majors is now decreasing and the increases in costs are outstripping productivity gains. At the same time, new ultra low-cost entrants, such as Spirit and Allegiant, may be nipping at its heels in the coming years with unit costs a full 25% lower than at Southwest.

Individual investors shouldn’t count out the airline just yet, however. Southwest, like Alaska, has a tradition of innovation and may also manage to break this vicious cycle.

Some people call unionized trucking companies “airlines on wheels.” Trucking is even more commoditized than airlines, as there are very low barriers to entry. Union carriers like Consolidated Freightways have either disappeared in Chapter 7 or merged and downsized like the twice-restructured and shrunken YRCW, the product of three of the four largest unionized carriers merged together: Yellow and Roadway, USF. These are in distress for the same reason; old union contracts pushed salaries and benefits to such a bloated level that other trucking companies could make money operating below the legacy truckers’ costs. As with the airlines, it’s hard to recommend that an individual investor be a long-term holder of a unionized trucking company.

There are unionized transportation companies that represent very attractive investment opportunities, however. The best examples are railroads (Norfolk Southern, CSX, Union Pacific), and the big package carriers, namely FedEx and UPS. These are able to prosper in concentrated industries with enormous barriers to entry. They do not need to fend off new entrants with lower costs driven by a young work force and attractive union contracts.

FedEx and UPS have the highest hourly airline wages in the United States, at $215 and $251 per hour for a 12-year pilot, respectively. They can afford to pay more than the airlines because they do not have to worry that somebody will invest $25 billion dollars and hire 200,000 people to start up a competing parcel service. When DHL tried to morph Airborne Express into a real domestic competitor, the company lost billions of dollars, shut most of the business down and left the domestic market. Much will be made about the USPS restructuring this year, but its network is really
We are now in the fifth year of a credit contraction cycle, the first aggregate credit contraction across all the major developed economies since the 1930s and the first in which central banks are aggressively attempting to reflate. While it is difficult to say what inning we are in, the eventual outcome is likely to be a far longer, powerful period of global economic prosperity.

Credit is the lifeblood of a capitalist system and previous credit contractions inevitably led to economic depression, deflation and widespread defaults. This time, however, the developed economies entered the cycle with fiat currencies (no connection to gold) which has enabled the central banks to provide an unlimited supply of credit to the banking system and government treasuries. As private credit has contracted, government credit has expanded by at least as much.

It remains to be seen whether these efforts in aggregate will prove successful. They may be only delaying a deflationary cycle or, conversely, setting us up for excessive inflation – creating an unusual amount of uncertainty. Looming Greek default is the next test and will need to be carefully managed by the European Union to avoid setting off an Italian debt crisis. Italy's sovereign debt load is the third largest in the world, after the United States and Japan, and a default would have far-reaching global implications.

An additional challenge is the management of the slowdown in China, home to the most rapid expansion of credit in the world – capital investment represents 50% of total GDP – and the current driver of more than a third of global economic growth. Other risks include a potential disruption in Middle East oil supply and the well-documented prospect of unsustainable government debt in the United States.

But the markets have discounted these risks to a large extent and, as we have seen, are now responding quickly to even slight let-ups in bad news with meaningful gains off depressed prices.

This is particularly evident in the United States, where the domestic economy is gaining ground as production expands and jobs are created at a slow but improving rate. U.S. corporations have managed well through difficult times; balance sheets are strong and profits margins high.

Also worth noting is the development in the United States of hydrofracturing, coupled with horizontal drilling. This new technology will stimulate billions of dollars of domestic investment in oil and gas exploration and drilling, possibly generating a boom in repatriated manufacturing capacity unimaginable just five years ago. Current plans for a new steel plant in Youngstown, Ohio may be the first of a number of similar developments in a reinvigorated United States.

We see increasing opportunities in this market for U.S. investors, as well as continued and considerable risks. But again, we cannot know what inning we are in. At Evercore Wealth Management, we build and manage well-diversified portfolios that attempt to properly balance both risk and return.

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Core Capabilities

Equities:

Equity Benchmarks

by TIM EVNIN

Equity investors who bill themselves as active managers but in practice hug their benchmarks do their clients a disservice. The result is inevitably an index-like performance, minus fees and taxes.

Worse still, benchmark investing can expose investors to extreme risk. Indices are usually weighted by the market capitalization of its component companies and can be dramatically distorted by a hot industry or investment theme.

At the height of the technology boom in 1999-2000, the technology industry represented less than 15% of the S&P 500 Index’s earnings, but a full 30% plus of its capitalization. In other words, the tech companies’ earnings were being valued at a huge premium to the rest of the market. When the tech bubble burst in 2001, the S&P 500 lost 50% over the subsequent two years, forcing index investors to realize how concentrated their exposures really were.

At Evercore Wealth Management, we measure our core equity portfolios against the S&P 500, but we do not use the Index as a guidepost to help us choose specific investments or manage industry exposure. Instead, we seek to prudently take on
some risks while deliberately avoiding others. These decisions are based on our quantitative and qualitative analysis of specific businesses and company valuations, not on the correlation of the portfolio as a whole to the Index.

Proper diversification is key. We carefully construct portfolios for clients to include companies in different industries and geographic end markets and to represent a range of capitalizations and stages in business development. But this diversification is focused on absolute risk not “benchmark” risk.

Our goal is to outperform the Index by 150-200 basis points per annum over time. We strive to accomplish this in a tax-efficient manner, which can add significant incremental value. We will invest where we have the highest conviction, and while we measure our performance against the S&P 500, we do not invest to align our client portfolios with it.

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Fixed Income:
New York
by HOWARD CURE

While municipal yields are likely to remain low by historical standards though 2012, there are significant pockets of opportunity in some areas of the country. Some of the most striking examples might just be right in the heart of New York City.

Current major Manhattan real estate development projects represent an opportunity for individual investors. The city, in recognition of the need for investors to diversify their municipal holdings (and its own need to stay within legal debt limits), has developed a number of different types of debt and securities to finance its capital expenditures. These can provide investors with a range of yields without significantly sacrificing credit quality.

The projects which include: a total $3 billion bond issuance for Hudson Yards, a 45-block area near Pennsylvania Station allowing for the expansion of the Midtown central business district, as well as for the realization of the development potential of Manhattan’s far Westside; a $1.25 billion offering for 4 World Trade Center issued through the New York Liberty Development Corporation; and the construction of Applied Sciences NYC, delivering on Mayor Michael Bloomberg’s vision for a technology campus at the cost of $100 million for the city.

Economic diversification is a fundamental credit strength for any municipality. A single factory town is vulnerable to market fluctuations — and no market fluctuates as often or as widely as the securities industry that dominates New York City. Still, it does create very lucrative jobs. For New York, the trick will be to diversify its economy while preserving its existing securities industry base.
Wealth Planning: Wealth Transfer Planning in 2012
by CHRIS ZANDER

On December 17, 2010, President Barack Obama signed The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act). From an estate and wealth transfer planning perspective, the 2010 Tax Act favorably changed the estate, gift and generation-skipping transfer tax, or GST, provisions for the years 2011-2012. The gift tax and estate tax exemptions were unified at $5 million per individual and the GST tax exemption was increased to $5 million per individual. The top gift tax, estate tax and GST tax rate was lowered to 35%. These changes allowed for more of an opportunity to transfer wealth both during life as well as at death under the increased exemptions. As 2011 drew to a close, many clients and advisors were left speculating whether or not the Joint Select Committee on Deficit Reduction would reduce the gift tax exemption from $5 million to $1 million by November 23. However, this did not occur.

For the year 2012, the current estate, gift and GST exemption amount is indexed for inflation and increased to $5,120,000. However, unless Congress acts on January 1, 2013, the estate, gift and GST exemption amount will be reduced to $1 million and the top tax rate will be increased to 55%. Although we believe that the probability is low that Congress will act prior to the end of 2012, we recommend that clients who have decided to make substantial gifts do so now. First steps, however, should be to evaluate individual financial lifestyle objectives and legacy goals for heirs and for charitable beneficiaries to determine the appropriate level of wealth transfer to implement today. Also, given the changes that have occurred in the last few years, it is important to consider how an existing estate plan currently utilizes the available exemption amounts.

Asset values continue to be depressed and interest rates are still historically low (the 7520 rate for January is 1.4%). Clients who are not inclined to give away the principal of their assets today may still find it an opportune time to implement strategies that involve giving away future appreciation. Worth considering are strategies such as a Grantor Retained Annuity Trust, an installment sale to an intentionally defective grantor trust, or other estate freeze options. In 2012, the gift tax annual exclusion amount per recipient will remain at $13,000 for gifts made by an individual and $26,000 for gifts made by a married couple.

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Staying on the Same Page
by JUDY MOSES AND WENDY BARASCH

Considering how much time and energy is invested in building wealth, couples spend surprisingly little time together on the planning necessary to achieve the family’s goals. At a recent Wise Women event hosted by Evercore Wealth Management in New York, the speaker noted that almost 90% of women will at some point in their lives be responsible for their assets — but are often entirely unprepared for the related challenges and opportunities.

That’s a potential liability for couples, as well as for individuals, as families benefit from the active participation of both partners. Even if one spouse — male
or female – has considerably more financial experience than the other, the family as a whole will be better served from their shared engagement in their financial future.

Quarterly or other regular meetings to review financial plans and investments provide a good forum for couples to express their views on issues relating to managing their family wealth, risk tolerance with regard to their investment portfolio, gifting to children and philanthropy. These can also be an opportunity for the spouse who has less interest in or knowledge about the family finances to come up to speed. When spouses work together to set and prioritize goals, their financial and investment plan will better reflect the shared needs, circumstances and values of their family.

A couple that works together to manage their family wealth is better prepared to make financial decisions as they arise, in both bad times and good. A solid understanding of the family’s cash flow needs and assets can make a job loss, for example, a manageable event, not a devastating one. On a happier note, an entrepreneur may receive a round of venture funding or sell a company. Having a plan in place to manage wealth transitioning from a productive yet illiquid asset to a liquid asset is critical.

The increasing use of stock-based compensation can also cause big swings in a family’s financial position and should be factored into the financial and investment plan. More commonplace issues are almost certain to arise. Both partners will need to have a view on whether an adult child should be provided with a down payment, either as a gift or through an intra-family loan, to start a business or make a down payment on his or her first home. And they will need to agree on how best to allocate assets among multiple children and grandchildren.

It’s critical that both partners understand what assets are required to maintain lifestyle and other commitments and that they are able to share their views on future wealth transfers. Developing a plan together that identifies which causes or organizations the family would like to support and through what type of vehicle, family foundation, donor-advised fund or direct gift makes implementing shared goals more efficient and, ultimately, more rewarding.

“‘A couple that works together to manage their family wealth is better prepared to make financial decisions as they arise.’”

Judy Moses and Wendy Barasch contributed to this article. Judy is a Partner and Portfolio Manager at the Evercore Wealth Management office in San Francisco; she can be contacted at moses@evercore.com. Wendy is a Partner and Advisor at the firm in New York; she can be contacted at wendy.barasch@evercore.com.
Editor’s note: Small cap stocks were poor performers in 2011, with the Russell 3000 Index returning just 1% and the Russell 2000 Index, which measures the performance of the 2,000 smallest companies in the broader index, down 4.18%. Investors who focus in this space argue that a continuing U.S. economic recovery and current valuations bode well for the sector this year. Here, we interview Philip Tasho and Tim Holland, co-managers of the TAMRO Small Cap Strategy.

Q: How do you define your investment universe?
A: For our Small Cap Core strategy, we focus on companies within the Russell 2000 Index that meet certain liquidity, market cap and sell-side coverage requirements. These screens typically leave us with 1,000 domestic small cap companies as potential investment candidates for a high-confidence, yet diversified portfolio.

Q: How would you describe your investment process?
A: The five-step investment process at TAMRO Capital Partners is opportunistic and independent. After we screen the small cap universe of companies, we turn our attention to the companies that rank in the top 30% and focus on fundamentals and pricing opportunities at the stock level, rather than any growth/value style box classification.

Our independence allows us to rely on our own investment professionals to discover companies possessing a sustainable competitive advantage where the potential investment gain is at least three times the potential investment risk at the point of purchase, based on our analysis.

Companies that possess this advantage have three key characteristics in common: management teams with a track record of success; strong financials; and a leading market share in their core product or service offering. It is the mispricing of the company’s common stock that makes these great companies into great investments.

Q: How is the portfolio typically constructed, in terms of number of holdings, sector weightings and position size?
A: Ultimately, we are building a diversified, high-confidence portfolio of 50-70 of our best ideas for both our small cap and large cap strategies. Weightings by sector are largely determined by where we see opportunity at the stock level. However, to ensure diversification at the sector level, we specify limits for major sectors (those equal to or greater than 7.5% of the benchmark) of 25-200% of the benchmark sector weight. For minor sectors (those less than 7.5% of the benchmark) our exposure will be between 0-15% of the portfolio. Average position sizes are 1.5%-2%. We tend to build positions incrementally.

Q: Has the market volatility of the past year influenced the positioning of the portfolio?
A: We have sought to take advantage of the market’s more dramatic swings to opportunistically take profits or add to fundamentally attractive positions. Given the number of unsettled macroeconomic issues, our expectation is for continued volatility. We will remain focused on company fundamentals and valuations—a focus that has historically served our strategy well.

Q: What sectors or industries do you find most attractive in this environment of slower economic growth?
A: Overall, we remain constructive on U.S. equities for several key reasons, including valuation, operational performance and balance sheet liquidity. We have identified particular pockets of strength. For example, we see great opportunity among small, well-capitalized regional banks, which should benefit from a multi-year consolidation cycle, including both open market and FDIC-assisted transactions.

Software as a service is another powerful trend because of the cost benefits and operational efficiencies it offers. We expect strong spending to continue within this particular area of information technology.

Finally, domestic companies participating in the unconventional extraction of oil and...
Chris Zander Ranked Among the “Power 25”; Comments on Gifting in New York Times

Chris Zander, a Partner and the National Head of Wealth Planning at Evercore Wealth Management, was ranked sixth in the annual “Power 25” by Private Asset Management Magazine. “As a partner of Evercore Wealth Management, Zander’s background, knowledge and approach to his clients fosters an environment of trust,” the publication noted. “His clients know that their interests are at the forefront and that his ideas are structured to meet clients’ needs first, regardless of the benefit to him or his firm.”

Separately, Chris was quoted by the New York Times in its annual report on philanthropy, published on November 1, 2011. He discussed a range of gifting strategies and some of the related tax implications.

Charlie Ryan Featured in Investment News Coverage of Top RIAs

Charlie Ryan, a Partner and Portfolio Manager at Evercore Wealth Management’s offices in New York, participated in the annual Investment News panel of top advisors. The firm was earlier named the fastest growing RIA of its size in the United States. Evercore Wealth Management now manages $3.2 billion in client assets.

Wise Women Gather in New York City

Evercore Wealth Management hosted a pilot discussion panel for women in New York. Topics included the relative roles of spouses in estate planning and investing, as well as related investment strategies. For information on future events, contact Wendy Barasch at wendy.barasch@evercore.com.

San Francisco Office Hosts CLE Event

The San Francisco office hosted a Continuing Legal Education seminar on January 18. The lawyers who attended received credit for the ethics component of the program. For further information, please contact Iain Silverthorne at silverthorne@evercore.com.

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gas are interesting as the U.S. economy continues to recover, energy consumption picks up, and as new export markets open up globally.

Q: Small cap indices lagged the broader market in 2011. Do you see that trend changing in 2012?

A: The one positive point to the relative underperformance of small cap equities last year was that it helped reduce the valuation gap between small and large that existed after the market’s rally off the 2009 bottom. We don’t know if small cap will outperform or underperform large cap in 2012, but we do see attractive investment opportunities down the capitalization spectrum and remain very constructive on U.S. stocks in general.

Our hope is that as macro concerns dissipate, investors will once again turn their focus to company fundamentals and see what we at TAMRO Capital Partners expect to see: well-capitalized companies that are executing well and trading at attractive valuations.
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. Our firm is founded on three core principles: independent advice; undiluted investment expertise; and the value of partnership.

For more information, please visit www.evercorewealthmanagement.com or call us at 212.822.7620 or 415.229.8080.