The outlook for the global economy is clearing, as capital growth in the United States helps drive, at long last, a recovery in the markets to pre-2008 levels. But as corporations rush to buy back their own shares in record numbers and to merge and acquire, many individuals and institutions continue to sit this bull market out, focused more on broad risks than specific opportunities.

It’s a question of perspective. In other words, and with apologies to Anaïs Nin, investors don’t see things as they are; they see them as they are.

These divergent perspectives – those of management and the investing public – have characterized much of this market. While individuals just recently became net buyers of stocks, the only meaningful investors in equities over the past four years have been U.S. corporations buying their own stock, increasing their dividends and making cash acquisitions – activities which, taken together over this period, have exceeded all new issuance of stock, including initial public offerings. The market as a whole has shrunk.

How can we see this market for what it actually is? As professionals who invest on behalf of private investors, the correct view seems to us near the midpoint and

(continued on page 3)
A message from the CEO

Americans 65 and older are, increasingly, remaining active in the workforce. That suits me fine, as I love what I do. It’s not everyone’s choice, of course, and many feel that they don’t have a choice to make. But working into late life has become one of the many defining characteristics of my generation: the aging baby boomers.

At Evercore Wealth Management, we have 26 partners serving clients across the United States. Each one of those partners has a great deal of experience in matters financial, but I am the only partner who can speak from the perspective of someone born at the beginning of the post-war baby boom. I turned 65 last year, joining the 13% of Americans who are labeled senior citizens. The discounts are great; other aspects are less appealing.

With the encouragement of my younger colleagues, I plan to write a regular column for Independent Thinking, starting with the next issue, to highlight some of the wealth planning issues that confront us all, sooner or later.

My situation is less complex than many. I spent 33 years at U.S. Trust, most recently as the CEO, before establishing Evercore Wealth Management with Evercore Partners in 2008. I have had the great satisfaction of seeing both firms prosper since. On a personal note, I have been married to the same woman for 40 years and have two married children and, so far, two grandchildren. And my involvement in a range of nonprofit activities has been very rewarding. In short, I am a fortunate man. But getting older, as Bette Davis famously put it, “is not for sissies.”

I know this not only through my own experience, but also that of my parents, both of whom are alive in their 90s, albeit no longer playing golf. I know it also through my years of close engagement with generations of clients, and their families, and through my nonprofit work with a hospital and geriatric institute in New York. In other words, I feel confident that I can share a broad perspective on the challenges – and the privileges – facing aging baby boomers.

My column will tackle subjects ranging from financial planning (including a hard look at the domicile issues of those of us in high-tax jurisdictions), protecting ourselves and our assets as we age and in the event of failing faculties, and providing for our heirs and funding our philanthropic interests.

I am very much hoping these thoughts can spark a dialogue, and that we can share our experiences to our benefit and that of our families and friends. Please feel free to contact me, or any of the partners at Evercore Wealth Management, to raise topics and to join in this conversation. There are, after all, a lot of us in this together.

Jeff Maurer
Chief Executive Officer
we are allocating assets accordingly, in the context of our clients' specific goals. But first, a look at the two extremes:

Many U.S. companies managed cautiously and well through the recession and were slow to hire and make capital investments even as they began to identify opportunities for growth. Corporate earnings have rebounded strongly over the past four years and are now at all-time highs, with record profit margins. Tim Evin weighs in on several of our holdings on page 18.

Some of the risks that loomed so large just months ago have receded. The euro has yet to collapse (and became far less likely to do so last summer when Mario Draghi said that the European Union would do "whatever it takes to preserve the euro"), and inflation in all the major markets remains at bay, despite record money printing, as investors continue to focus on liquidity.

Congress is muddling along and, while the reduction in the federal deficit as a result of the tax rate increases agreed to at the beginning of January and any additional spending cuts will be drag on the economy, it’s important to note that we have been experiencing fiscal drag for the last 18 months. In fact, if the government sector is excluded, real gross domestic product growth in the United States improves to 3.5% from 2.5%. The private sector has enough momentum to withstand moderate additional fiscal drag.

And, as we have mentioned in the past several issues of Independent Thinking, the increase in oil and gas production in North America as a result of new drilling techniques is a very powerful economic positive and could soon translate into increased manufacturing activity in the United States, a further boon for many corporations.

These are all very encouraging developments. It’s not surprising then that American corporate management has a fairly rosy outlook, although some observers wonder if the rush in stock buybacks is evidence that corporations do not see enough growth opportunities in which to invest. It is difficult to argue with the value of the strong cash flow supporting

**U.S. Crude Oil Field Production & Imports of Petroleum Products**

A dramatic trend reversal.

[Graph showing U.S. Crude Oil Field Production & Imports of Petroleum Products]

Source: Yardeni Research, Inc.

**Global Growth**

GDP growth in U.S. and Europe is subpar. Growth in China is slowing from its 2007 peak rate of 14.2%.

[Graph showing GDP growth rates for US, Euro Area, China, and World]

Source: IMF
these buybacks, however, and we applaud prudent management that did not chase growth for growth’s sake and instead returned cash to investors.

But the view on the ground is very different from that in the boardroom. GDP growth remains subpar and, significantly, labor has not participated in this recovery, as demonstrated by persistently high unemployment and a drop in real median income. Intense international competition for jobs, weak unions, an ineffective education system and management incentives to maximize profits have slammed the brakes on a century-long improvement in real wages.

While workers in the past would have expected to realize at least half of their productivity gains in the form of real wages, today virtually all improvements in productivity from advancements in technology, such as robotics, have accrued to the benefit of corporations. While the imbalance between earnings and wages is causing increasing income inequality, we do not see a change in the trend anytime soon. However, the job market should strengthen on a cyclical basis over the next two years as the construction industry finally comes around and corporations slowly begin to hire.

In the interim, it’s hardly surprising that individual investors and related institutions, still reeling from the events of 2008 and the monetary and fiscal dramas since, have yet to express much confidence in the markets. And they are right to perceive continued, albeit diminished, risks. Europe, while committed to a shared currency, remains mired in recession as austerity measures take hold and Congress has yet to tackle an unsustainable level of entitlement spending. And the long-term impact of the billions of dollars the Federal Reserve has pumped into the banking system remains a major concern. In short, last year’s risks are all still with us, now more like monsters under the bed than ones blocking the door.

As investors for individuals, families, and institutions, it is our job to take a balanced view; to exploit opportunities while remaining mindful at all times of the associated risks. These concerns shape our perspective and drive our asset allocation ranges, which serve as building blocks for our partners as they customize asset allocations to our clients’ wealth management objectives.

At present, we are underweight defensive assets, discouraged by the historically low yield on investment-grade bonds and mindful of an eventual rise in interest rates. It is currently near impossible to earn a positive real return from investment grade municipal bonds without extending maturities excessively. We favor a number of strategies that take on credit risk by buying securities that are below investment grade but that have little or no interest rate risk because of floating rates or very restricted durations.

We recently eliminated our in-house diversified market hedging strategy because we found the expense of directly hedging the equity market disproportionate. We have replaced the strategy with a number of outside funds that have demonstrated an ability to earn positive returns while having little or no correlation to the markets, as well as positions in gold and, at times, strong foreign currencies to hedge against the risk of a devaluing dollar and eventual inflation.

We are neutral on growth assets as a whole while remaining positive on the equity market, expecting returns close to our 10-year annualized projected return of 8%. It is interesting to note that the only reason the market is not at a new all-time high is because the market sold for 15 times earnings at the high in 2007 and only sells for 13 times 12-month forward earnings today: This suggests significant further scope for upside when individual and institutional investors return to the market.

John Apruzzese is the Chief Investment Officer at Evercore Wealth Management. He can be contacted at apruzzese@evercore.com.
The 2008 financial crisis and the Great Recession that followed have had devastating effects on the U.S. economy and millions of American lives. But the U.S. economy will emerge from its trauma stronger and widely restructured. Europe should eventually experience a similar strengthening, although its future is less certain and its recovery will take longer to develop. The United States is much further along because its financial crisis struck three years before Europe’s, in 2008, causing headwinds that have pressured it ever since. It will take another two to three years for these to subside, but after that, U.S. economic growth should outperform expectations. In contrast, Europe is still in the midst of its financial crisis. If historical logic prevails there, it will take four to six years for strong European growth to materialize.

Such strengthening in both regions will occur for one major reason: The crisis years have triggered wide economic restructuring. Sweeping changes in government finances, banking systems, and manufacturing are under way, as are structural reforms in labor markets. All this is proving once again that global capital markets, the most powerful economic force on earth, can effect changes beyond the capacity of normal political processes. And in this case, they can refute all the forecasts of Western economic decline. Indeed, in the years ahead, the United States and Europe could once again become locomotives for global economic growth.

This is not to say that the crises were worth the pain; they most definitely were not. There is palpable suffering on both sides of the Atlantic due to unemployment and government austerity measures. It is tragic that so many people have lost their jobs and will never recover them. And it is socially corrosive that the crises have accentuated existing trends toward greater income inequality. But these events happened, and the subject being addressed here is their long-term impact.

The U.S. economy has been expanding “albeit in fits and starts” since the recession’s trough, in June 2009. Europe, however, is on an entirely different timetable. Unlike those in the United States, Europe’s financial systems did not implode in 2008. There were severe problems in Ireland and the United Kingdom, but capital markets did not revolt against Europe as a whole, and thus, there was
not a large fiscal or monetary response. It was not until 2012, when the sovereign debt and banking crises hit the continent in full force, that the Eurozone confronted problems comparable to those that had afflicted the U.S. economy in 2008-09. As of today, therefore, the Eurozone’s GDP is still shrinking, and its recession may not have bottomed out yet. Having experienced its crisis first, the United States now faces a shorter path to recovery. Yet if European countries can restructure their economies to the degree that the United States has, there will be cause for optimism.

The economists Carmen Reinhart and Kenneth Rogoff have argued that periods of economic recovery after financial crises are slower, longer, and more turbulent than those following recessions induced by the business cycle. The painfully slow recovery in the United States and the sharp economic stress in Europe corroborate this thesis. But history is filled with examples of countries whose economies grew stronger after financial implosions. Following the Asian financial crisis of 1997-98, South Korea accepted a tough bailout package from the International Monetary Fund, strengthened its financial system, and increased the flexibility of its labor markets; soon thereafter, it enjoyed an economic boom. In Mexico, the economy has performed well ever since the collapse of the peso and the U.S. rescue package of 1994. A similar phenomenon occurred in parts of Latin America following the sovereign debt crises there in the late 1980s. Although these financial crises were far smaller than the 2008 collapse in the United States, they followed the same pattern, with capital markets rejecting the old order – and then inducing major economic restructuring.

**Restructuring America**

Why will the recent crises eventually strengthen the U.S. and European economies? In the United States, a resurgent housing sector, a revolution in energy production, a remodeled banking system, and a more efficient manufacturing industry will fuel a boom. Meanwhile, the reelection of President Barack Obama and the looming “fiscal cliff” have increased the prospects of a grand bargain on deficit reduction and a solution to the country’s debt problem.

First, after suffering a catastrophic collapse, the U.S. housing market is now poised for major, multiyear growth. Historically, when the U.S. housing sector has been pushed down far enough for long enough periods of time, it has eventually rebounded to very high levels. Before the recent crisis, the housing bubble had inflated so much that when it finally burst, the sector truly collapsed. Between 2000 and 2004, an average of 1.4 million single-family homes were built per year, but that number declined to 500,000 after the crisis and remained there until recently. Sales of new homes, which averaged 900,000 per year during the bubble, fell by two-thirds after the bubble popped. And overall residential investment, which accounted for four percent of U.S. GDP from 1980 to 2005, has averaged only 2.5 percent since 2008.

Although the housing collapse meant disaster for millions of homeowners who could not service their mortgages, it also cleared out the abuses and excesses that had plagued the sector for years. As a result, U.S. banks have spent the last few years improving their mortgage underwriting standards and securitization markets, and household attitudes toward mortgages and home-equity financing have become healthier. Now, the housing sector has finally turned a corner, with a key home price index – the S&P/Case-Shiller 20-city composite – rising by eight percent since March 2012. The levels of relevant supply have fallen sharply (in other words, fewer homes are for sale), mortgage credit is more readily available, and population growth, coupled with a recovery in household formation rates, is likely to drive high demand – all of which means that house prices are bound to keep growing. These factors
are likely to boost total residential investment, which includes new construction and home remodeling, by 15-20 percent over the next five years. This change alone could add one percentage point to annual U.S. GDP growth and as many as four million new jobs to the economy.

Second, new technologies are producing a spectacular turnaround in U.S. oil and gas production. Advanced seismic techniques and innovative approaches to hydraulic fracturing and horizontal drilling have opened energy deposits that were previously unknown or inaccessible. The result has been a dramatic recovery of both the natural gas and the oil industries. In 2012, U.S. natural gas output reached 65 billion cubic feet per day, which is 25 percent higher than it was five years ago and an all-time record. Shale gas accounted for much of this increase. Meanwhile, U.S. oil output has soared. It is estimated that in 2012 alone, the production of oil and other liquid hydrocarbons, such as biofuels, rose by seven percent, to 10.9 million barrels per day. This marks the largest single-year increase since 1951.

Moving forward, the U.S. Department of Energy forecasts that American liquid hydrocarbon production will rise another 500,000 barrels in 2013, and the International Energy Agency projects that the United States will surpass Saudi Arabia as the world’s largest oil producer by about 2017. Overall, this energy boom could add three percent to U.S. GDP over the next decade, in addition to as many as three million direct and indirect jobs, almost all of which will pay high wages. The United States could cut its oil imports by one-third, improving its balance-of-payments deficit. Also, the higher natural gas output will reduce the average consumer’s utility bill by almost $1,000 per year, representing a further stimulus to the U.S. economy. And the American public’s hunger for economic recovery and jobs has softened opposition to this energy revolution.

Third, negative publicity aside, the U.S. banking system has been recapitalized and thoroughly restructured since 2008. No one could have reasonably imagined the speed of the improvements in banks’ capital and liquidity ratios that have occurred since then. The largest banks have consistently passed the rigorous stress tests administered by the U.S. Federal Reserve, and, surprisingly, they are well ahead of schedule in meeting their required capital ratios under the Basel III international regulatory framework. Midsize banks are in even better shape. Although the job is not yet finished, these institutions have rapidly rid themselves of their troubled legacy assets, especially mortgage-backed securities. Both large and midsize banks have divested from broad swaths of assets and raised substantial new capital from public and private sources. In many cases, moreover, they have revamped their management teams and boards of directors. In light of these changes, the earlier, acute concerns about the financial stability of U.S. banks have largely dissipated.

In fact, banks are already lending aggressively again to both businesses and consumers. According to the Federal Reserve, outstanding loans to U.S. businesses now total $1.45 trillion, having increased at double-digit rates for each of the past four quarters. This number is still below the 2008 peak, but the gap is closing quickly. In terms of consumer credit, the previous record high was surpassed in 2011, and the total rose by another three to four percent in 2012. All this credit is boosting GDP growth, and the banking sector is likely to expand its loan totals consistently over the next few years.

Fourth, the Great Recession has quietly spurred greater efficiencies in the U.S. manufacturing sector. Unit production costs are down by 11 percent in the United States compared with ten years ago, even as they continue to rise in many other industrialized countries. And the differences between U.S. and Chinese labor costs are narrowing. The U.S. economy
has added half a million new manufacturing jobs since 2010, and this growth should persist for a number of years. The transformation of the U.S. manufacturing sector is perhaps best reflected in the auto industry. In 2005, U.S. automakers’ hourly labor costs were 40 percent higher than those of foreign producers that operate plants in the United States. But today, these costs are virtually identical, and the Big Three – Chrysler, Ford, and General Motors – have regained market share in North America.

The resurgence of the housing and energy sectors will also positively affect the manufacturing industry. Given that the outlook for residential construction is so strong – and considering that new homes contain so many manufactured products – further manufacturing job growth is a near certainty. Moreover, decreasing natural gas prices will aid the petrochemical sector and all types of manufacturing that use this fuel.

Finally, although there are no guarantees, the chances that Washington will fix the national debt problem have increased. With Obama citing deficit reduction as the foremost goal of his second term – and with election results that were unfavorable to Republicans, whose anti-tax position now lacks public sanction – the prospects for a decisive deficit-reduction agreement have improved. If this occurs in 2013, it will provide a further boost to business and investor confidence, as well as to overall private investment.

**Hope for Europe**

In Europe, there is less evidence, so far, that economies will emerge stronger from the crisis years. This is largely because after a sharp dip in 2008, Europe was recovering until the Eurozone’s twin sovereign debt and banking crises struck in 2011. Furthermore, compared with that of the United States, the amount of economic restructuring required in Europe is deeper and harder to achieve. In part, this reflects the sheer complexity of the European Union, which is composed of 27 very different countries. It is also an outgrowth of the inherently inflexible, sclerotic nature of many European economies. Therefore, the consequences of the European crisis and the question of whether it will truly lead to wide-scale restructuring remain unclear. Nevertheless, it is logical that large and positive changes could emerge, and a few encouraging signs are already visible. The Eurozone has been fitfully moving toward fiscal union and banking reform. Across the EU, economies are boosting their productivity and making their exports more competitive, and governments are reining in their public sectors.

There are also precedents within Europe of restructuring and strengthening after major financial crises, such as Sweden’s experience in the 1990s. In that case, a credit and real estate boom coincided with a long period of public-sector expansion and a debt-to-GDP ratio of around 80 percent. Sweden, at the time, was widely considered the model of the European welfare state. In 1992, however, its banking system collapsed and unemployment rose to 12 percent, triggering wide-ranging economic, fiscal, and banking reform. Stockholm raised taxes, deregulated the electricity and telecommunications sectors, and slashed federal spending, including on pensions and unemployment benefits. All these steps improved Swedish competitiveness and boosted GDP growth, which rebounded to four percent two years later, in 1994.

In the Eurozone today, governments are making tentative progress. Consider, for a start, the fiscal side, where there has been movement toward instituting a central fiscal authority with meaningful control over budgets and debt on a country-by-country basis. The Eurozone members will probably not accord the eventual fiscal union with the legal authority to completely reject national budgets. Still, if it has credibility in financial markets, the fiscal union will possess real power, because its expressions of disapproval could induce punitive reactions from those markets.
Second, the Eurozone’s decision to give the European Central Bank supervision over the continent’s largest private banks is also a major step forward. As a result of this move, these banks will finally be regulated in a modern, transparent, and independent fashion—a far cry from the present situation, in which weak local overseers coddle the banks. It also moves the European Central Bank closer to the more powerful and flexible model of the U.S. Federal Reserve. This is an essential change.

To fully repair its banking system, the Eurozone needs an entity similar to the United States’ Troubled Asset Relief Program, known as TARP, and the recapitalization of Spain’s banks is a first step in that direction. The EU’s bailout fund, the European Stability Mechanism, is providing Spanish banks with capital conditional on an overall cleanup of their balance sheets. If this approach were adopted throughout Europe, it would ultimately produce a healthier financial system.

Third, some countries in Europe are in the process of improving their structural productivity problems, which were a major, albeit less widely noted, contributor to the crisis. It looks increasingly possible that the least competitive European economies, mainly located along the continent’s southern periphery, will make substantial improvements in productivity. Without local currencies to depreciate, these countries have been cutting costs through internal devaluations, which involve cutting labor inputs. In Greece, Portugal, and Spain—the Eurozone countries under the most financial pressure—unit labor costs have fallen significantly since 2010. These countries have also initiated crucial labor-market reforms, such as curbing minimum-wage requirements and eliminating restrictions on hiring, firing, and severance. Ireland’s path is instructive. After the Irish banking system collapsed in 2008, Dublin cut manufacturing costs sharply and boosted productivity. Today, just a few years removed from its crisis, Ireland is again one of the most efficient places in Europe for production.

Fourth, exports in the peripheral countries—which have long labored under large trade deficits with Germany and other northern European states—are regaining their competitiveness. As a result, Italy, Portugal, and Spain now enjoy reduced deficits in both trade and their current accounts, reflecting the lower costs of their exports and a weaker euro. In Greece, despite the severity of that country’s economic fall, the absolute level of exports has returned to precrisis levels.

Finally, by beginning to trim their public sectors, Eurozone governments are playing an important role in the continent’s economic renewal, as these spending cuts will create more room for the private sector to grow. According to the European Commission, the collective deficit of the 17 members of the Eurozone fell to 4.1 percent of GDP in 2011, a significant decrease from the 6.2 percent figure in 2010. Moreover, the broader EU saw its collective deficit cut by one-third in 2011. To be sure, many of the European countries’ deficit-to-GDP ratios remain well above the official target of three percent, and debt actually grew faster than GDP in the Eurozone as a whole last year. Still, pressure from financial markets should continue to shrink European public sectors into the future.

Throughout modern history, severe financial crises have caused great pain to vulnerable segments of affected societies, but they have also often strengthened underlying economies. Both of these countervailing phenomena are asserting themselves in the United States today. Europe is inherently more fragile, but initial evidence suggests that the same dynamic is occurring there. If this historical pattern holds true, the United States and Europe could defy conventional wisdom and again lead growth in the world economy.
Wealth Planning
Tax Changes in Perspective

by Chris Zander

As all the sound and fury surrounding U.S. tax changes starts to ebb, Americans at every income level are realizing that they will pay more, with high-income taxpayers taking the biggest hits. Figuring out just how much and evaluating related planning strategies has become even more complicated, however. It is doubtful that most members of Congress know their marginal tax rate now.

An individual or married couple in the top bracket, defined as earning $400,000 or $450,000, respectively, are subject to federal tax at 23.8% on long-term capital gains and qualified dividends, up from 15%. Interest income or other ordinary income items from investments is subject to a marginal federal income tax rate of up to 43.4%. Wages or other compensation items, such as stock options or restricted stock income, are subject to a combined tax of 41.95%, up from 36.45%. The effect of the partial loss of itemized deductions and the expiring payroll tax cut effectively increase the marginal tax rate further, as do state income taxes, depending on residency.

Qualified dividends and municipal bond interest remain favorable in this new environment, at least for now. Income tax deferral strategies, such as deferring wages or self-employment income into qualified or non-qualified retirement plans, may also benefit many individuals who in recent years decided to accelerate that income at lower income tax rates. Likewise, investors holding concentrated, low-cost stock positions should now reconsider diversification and deferral strategies such as equity collars, prepaid variable forwards, and charitable remainder trusts (depending on their particular objectives) as opposed to just outright sales.

Many alternative investment strategies, which historically are less tax-efficient, have become less favorable, however, and proper asset location (e.g., IRAs, tax-deferred retirement plans) is important when including these as part of a high net worth investor’s plan.

While the limitations on itemized deductions, collectively known as “Pease,” have been reinstated, this outcome is more favorable to high-income taxpayers than many of the previous proposals, which either reinstated these limitations at lower adjusted gross income, or AGI, levels or specifically curtailed the benefit of certain itemized deductions. For those high-income taxpayers in low- or no-state-tax jurisdictions who have relatively few itemized deductions outside of charitable gifts, there are strategies that should be considered to maintain or enhance the after-tax benefit of charitable giving due to the higher threshold (such as doubling up contributions in one year in certain instances).

Another opportunity worth considering is the tax-free rollover distribution from IRAs to charities of up to $100,000 per year (for individuals age 70½ or older), which was temporarily extended through the end of 2013. Simple, this isn’t.

More significant still to many high net worth families is the continuity of the estate tax, gift tax and generation-skipping exemptions that remain at $5 million per individual and $10 million combined for married
couples. The top federal gift tax and estate tax rate was increased to 40% from 35% in 2012 but is now less than the 55% top federal tax rate that had been coming down the pike.

The current portability of the estate tax exemption and inflation indexation related to all of the above exemptions remains intact, resulting in the exemptions increasing to approximately $5.25 million in 2013. There are serious income tax consequences that impact the investment portfolios of non-grantor trusts, as Julie Krieger discusses below, and it is important to consult with your wealth advisor on this before implementing a long-term investment policy.

Chris Zander is the national head of wealth planning at Evercore Wealth Management. This article is extracted from a report published on January 2, 2013. To view the report in full, visit: www.evercorewealthmanagement.com/news/perspectives.php. Chris can be contacted at zander@evercore.com.

### Minimizing Increased Tax Costs for Irrevocable Non-Grantor Trusts

**by Julie Krieger**

While the gift tax and generation-skipping tax, or GST, exemptions are unchanged, the tax for many irrevocable non-grantor trusts is now higher. The tax rate on undistributed income from these trusts has risen to 39.6% from 35%, starting at taxable income of just $11,950.

At the same time, the top dividend and capital gains rates have increased to 20% from 15%. And the Affordable Care and Patient Protection Act imposes an additional 3.8% Medicare tax on the lesser of net investment income or taxable income above $11,950 for trusts. The resulting combined top tax rate is now 43.4% on undistributed income and 23.8% on qualified dividends and capital gains.

So, what can a trustee do to minimize the impact of the higher taxes? The first step should be to revisit the trustor’s intent before formulating options. Was the trustor’s intent to provide income and/or principal to supplement the current beneficiaries’ needs or was it to grow wealth for the benefit of the current beneficiary and future generations? When does the trust principal distribute and to which generation? Understanding the trust’s long-term goals should drive the trustee’s decisions.

(continued on page 12)
If the trustor’s intent was to generate long-term growth in wealth for the beneficiaries, trustees should consider a shift in the asset allocation to increase growth assets and reduce income-producing assets. An equity allocation could generate qualified dividends and long-term capital gains that are taxed at the lower 23.8% rate. Active management that can make customized decisions to defer gains and harvest tax losses will also be of a greater benefit.

For the fixed income allocation, trustees should consider tax-exempt municipal bonds. Does the beneficiary’s marginal tax bracket make a difference? Yes, a trustee will want to know the beneficiary’s marginal tax bracket and compare it to the trust’s tax bracket. If a beneficiary is in a lower tax bracket, the trustee may choose to distribute the income to take advantage of the tax savings. The other significant difference is that a trust is subject to the higher tax rates at a much lower threshold of $11,950 of income, while a single individual beneficiary’s threshold is $400,000 of income before the highest rate applies.

Following is an example of a trust earning $100,000 in interest income and $100,000 of qualified dividend income. Based upon the tax rate differences, there is a tax savings of almost $29,000 through distributing the income to the beneficiary.

A trustee should also consider if a distribution today will be in the beneficiary’s best interest. Does the beneficiary need annual income to supplement his or her living expenses? If not, will the beneficiary benefit more if the trust accumulates income and reinvests it for future growth? A good trustee is a resource to help the beneficiary develop responsible financial habits and understand sound investment practices.

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<table>
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<tr>
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<th>Marginal Tax Rate</th>
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</tr>
<tr>
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Potential Tax Savings: $28,713

*Trust rate includes the 3.8% Affordable Healthcare Act tax.

How do these tax changes impact future planning? In the future, those making gifts will want to weigh the increased trust tax costs against the protections gained by using trusts to limit the availability of assets to a beneficiary, mitigate future estate taxes, and protect the assets from potential creditors, including spouses. Some may want to consider changes to their revocable trusts and leave assets to a surviving spouse outright instead of using marital and credit shelter trusts. The portability of the exemption to the surviving spouse can preserve the use of the exemption. However, the advantage to using the credit shelter trust at the first death is that the appreciation on the assets following the first death is also exempt.

The increase in the trust tax rates and the lower threshold will require trustees to plan ahead to minimize the tax impact.

Julie Krieger is a Partner and Wealth Advisor at Evercore Wealth Management in Minneapolis. She can be contacted at julie.krieger@evercore.com.
Too Little, Too Late?

Hurricane Sandy

by Howard Cure

Perspectives on Hurricane Sandy have changed dramatically in months since the October storm slammed the New York metropolitan area. The local sense of urgency was lost in the national debate over the fiscal cliff. Three months later, the federal government finally approved $60.2 billion in aid, one-third less than the governors of New York, New Jersey and Connecticut had requested.

For investors, the challenge is to assess the distribution of these funds, both for immediate infrastructure repairs and for the long-term fiscal health of the region.

Initial forecasts for Sandy’s cost ranged between $10 billion and $50 billion. To date, the storm has cost at least $50 billion, making it one of the most expensive disasters in U.S. history. On paper, the federal government’s $60.2 billion seems more than adequate, especially as commercial insurance claims will offset another $7 billion to $15 billion. But having the money approved is not the same thing as having the ability to spend it. This bird is still very much in the bush.

More significant still is the long-term outlook for a metropolitan area that, as New York Governor Cuomo put it, is only a few feet above water. The associated costs have not begun to be tallied, but it’s likely that the remaining $13 billion in federal funds set aside for this purpose won’t make much of a dent.

It is critical to differentiate between the public entities that are investing for the long term and those focused on simply restoring the prior level of service and safeguards. Sandy has exposed a number of issuers to operational and budgetary risks that are just beginning to play out from a credit perspective. Overall, however, the credit rating agencies do not expect wholesale downgrades. Key credit factors that may expose an issuer to rating actions include the following:

- Near-term liquidity demands due to costs associated with cleanup and restoration could lead to temporarily lower cash balances or increased debt burdens. Because it is assumed that issuers will recoup most costs through federal disaster funding, these expenditures should represent only a temporary reduction in reserves.
- Countering potential liquidity issues are longer-term stimulus from rebuilding activity, funded in part with FEMA and private insurance, which has the potential to create measurable increases in economic activity and, ultimately, governmental revenue.
- Restoring service to previous levels for utility and transportation entities, funded mostly by FEMA, is a primary goal.
- Upgrading basic infrastructure projects to address the increased occurrence and severity of storms. There will be an impact on debt burden in addressing these long-term improvements.

It is encouraging to note that the capital markets remain accessible to nearly all investment-grade issuers, as many of the hardest-hit local governments have
issued notes to fund storm costs. As far as many of the New Jersey coastal towns are concerned, some of these issuers’ tax bases are likely to contract as owners of destroyed properties seek to appeal their valuations. Others fund their budgets with sensitive business activity revenues related to tourism, such as beach fees or marina slip rentals, which could be challenged depending on the pace and success of reconstruction. As a consequence of this uncertainty, some of these credits now have a negative rating outlook.

While most of the damage in New York City involved transportation and utility authorities, the city’s tax base is not immune to the potential for financial loss. Based on the New York City Independent Budget Office, or IBO, analysis of the city’s financial plan, the costs of rebuilding in Sandy’s wake – and taking steps to lessen the effects of future super storms – have yet to be fully tallied. While it remains unclear how much of that bill will fall to the city, the financial plan assumes all costs will be shouldered by others. It is also unclear if there will be longer-term economic and fiscal consequences. For instance, the storm laid bare the fragility of New York’s infrastructure, which may affect the decision of some businesses to locate, remain or expand in the city.

Our greatest concerns at present surround the large regional public utilities and transportation issuers, notably the Long Island Power Authority, or LIPA, and the New York Metropolitan Transportation Authority, or MTA. Please contact us for further information on these and other entities.

Given the extent of the damage, the region, with a few exceptions, has recovered well and leads us to believe in the full and timely repayment of our debt holdings. While the federal reimbursement amount is now resolved, we need to focus on the actual distribution of funds. In addition, we must look further out to the need to upgrade the region’s existing infrastructure system under the belief that these extreme weather patterns are no longer as rare as previously believed. The costs for these improvements can be burdensome, even in a region as dense and diverse as the New York metropolitan area.

We will continue to monitor the federal funding issues as well as the capital improvement needs and update our findings as new events develop. We will base our portfolio composition accordingly.

Howard Cure is the Director of Municipal Research at Evercore Wealth Management. To view the full version of his most recent report on Hurricane Sandy, visit http://www.evercorewealthmanagement.com/news/perspectives.php. He can be contacted at cure@evercore.com.
Editor’s Note:

The Evercore Wealth Management Diversified Market Strategies allocation is intended to offset risks to which traditional allocations of bonds and diversified stock portfolios are vulnerable. Here we interview Chris Dialynas, manager of the Pimco Unconstrained Bond Fund, one of the current holdings in the strategy.

Q: What does unconstrained mean, in the context of your fund?

A: PIMCO’s Unconstrained Bond Fund is an absolute return-oriented fixed income fund that invests in rates, currencies, and credit globally.

The fund is not benchmarked to a traditional bond index, such as the Barclays U.S. Aggregate Index, but rather starts from a blank slate, e.g., Libor. This means that the fund is not intended to track a static set of beta exposures, but rather can allocate trades to the most attractive fixed income sectors globally, based on PIMCO’s active management views and best ideas.

By removing the structural constraints of a traditional benchmark, the fund can potentially protect investors to a greater extent on the downside with the ability to avoid exposures that appear unattractive or even profit from them by going short. Given the fund’s absolute return mandate, greater flexibility, and broad guidelines, we would expect to achieve positive returns across most market environments.

Q: Can you define that absolute return mandate, and your goals for the strategy?

A: Absolute return strategies are designed to attain positive absolute returns in most market environments, independent of how broad markets are performing. These types of strategies are not tethered to a benchmark, and therefore not mandated to take on certain risk exposures, regardless of whether or not they are attractive at a point in time. Absolute return strategies are usually allowed to take long and short positions and have a global opportunity set. This allows us to source the most attractive returns from a broad toolkit of instruments, market sectors and currencies, while avoiding or shorting those exposures that appear to be unattractive. Broad manager discretion also allows the portfolio management team to implement our strategies most efficiently.
Q: The consensus thinking in the market seems to be that bonds are now overvalued and risky. Is that your view?

A: As yields hover near historic lows, investors are naturally concerned about the prospect of rising rates and the potential impact on their bond investments. While rates will no doubt rise eventually, we believe that bond yields will remain repressed for some time. The fund is therefore focused very defensively across most sectors.

The overall duration of the fund has been brought down close to net zero years, representing a combination of long and short exposures across geographies. We have long exposures in countries with relatively healthy balance sheets (U.S., Australia, Canada, Brazil, and Mexico), and are short interest rates in countries with expectations for rising inflation and rates on the horizon, including Japan. With an overall duration of close to neutral, the fund is insulated from a sharp sell-off in rates.

Q: What are the most appealing asset classes in the bond markets now?

A: In general, we currently like: intermediate U.S. rates, which have attractive roll-down characteristics; longer-dated U.S. TIPS, Australian rates, which provide relatively high real returns with potential for appreciation ahead of future rate cuts; selected developed and emerging market corporate/quasi sovereigns; and some emerging market local rate bonds and currencies.

Q: What other exposures does that fund have?

A: Outside of global yields, we continue to remain defensive in most sectors, and selectively offensive in others. Our select long corporate exposure in high-quality issues within financials and corporate/quasi sovereign emerging market debt is mostly hedged back with short high-yield credit positions, as we view high yield as an overvalued sector.

Our securitized exposure is focused in two areas: U.S. agency mortgage-backed securities and non-agency mortgage-backed securities. Within agencies, we view the sector as a whole as overvalued, in large part due to central bank involvement in the sector, which distorts prices across the mortgage coupon stacks. The Unconstrained Bond Fund is therefore mostly market neutral, focusing on long/short relative trades across coupons. Outside of agency securities, we continue to view the non-agency mortgage-backed securities sector as one of the few bright spots remaining in fixed income. These securities provide attractive loss-adjusted yields, even in fairly adverse housing scenarios, while participating in material price appreciation on a potential housing market recovery.
Q: How about currency strategies?

A: Currency strategies within the fund continue to provide unique alpha opportunities, diversification, and hedges to broad market risks. We continue to be mostly long the U.S. dollar against currencies heavily reliant upon credit and growth, including the euro and Australian dollar. These currencies also provide attractive left-tail hedges, as they are highly correlated to global risk sentiment. We are also long select emerging market currencies that we believe to have attractive yields, relatively robust balance sheets, and higher growth prospects.

Q: Derivatives have become a dirty word on Main Street, but the fund employs them quite regularly. What role do derivatives play in the fund?

A: Derivatives are used extensively in this fund and take on a number of different roles. Currency forwards, for example, are often used as an efficient and liquid means to obtain foreign currency exposure. Derivatives are also often used to obtain short exposure and hedge certain risks in the portfolio. Pay-fixed interest rate swaps, as an example, are commonly used to hedge unwanted long interest rate risk from securities like corporate bonds or mortgage-backed securities. Finally, derivatives can be utilized in relative value strategies, cash/derivative basis trades, and conditional/convexity options-based trades to enhance the overall alpha generation of the strategy.

Q: Funds that have no obvious or perfect benchmark sometimes struggle to determine the best way to measure their performance. How do you know if you are doing a good job for investors?

A: The performance of the Unconstrained Bond Fund should be measured against our stated goals; to achieve positive absolute returns across most market environments, with a target return of Libor plus 3–4%, with a corresponding volatility of the core bond market (approximately 4–6% per annum); to approach investing with a keen focus on downside protection and capital preservation; and to maintain low correlations to broad asset classes over full business cycles.
Growth Assets
Another Good Year

by Tim Evnin

Buying and holding businesses that work on your behalf, pay or might well pay dividends, and have tax advantages over other sources of income: What’s not to like?

After a year in which equities generated excellent returns (16% for the S&P 500 in 2012, 17.3% for the EAFE index of developed markets outside North America, and 18.2% for emerging markets), they still look good, both in relative and absolute value terms. In addition, the recent changes to the tax code continue to make both dividends and long-term capital gains attractive, compared with earned and interest income.

In contrast, bonds look expensive. Two-year treasury notes are yielding 0.26% and 10-year notes are yielding 1.99%, as of writing. With inflation hovering around 2% and interest earnings subject to tax, bonds have lost a lot of ground to equities.

More important, equities are fairly valued on an absolute basis. While earnings growth for the S&P 500 slowed quite significantly toward the end of 2012, it appears to have stabilized since. At the same time, American corporate management seems more confident about growth for this year. Market analysts do too, with consensus earnings estimates at $115 per share and growth predicated at approximately 8% over 2012 for the S&P 500. This puts the market at a bit under 14 times 2013 earnings, or roughly a 7% earnings yield. Not cheap, but not dear either.

At the same time, many public companies are in the best financial shape they have been in for years. Aggressive cost cutting from the very difficult 2008-09 period has boosted productivity and efficiency while the bar seems to have been raised on reinvesting capital, due to a cautious outlook on global economic growth and uncertainty around U.S. policy. Cash on U.S. corporate balance sheets is at record levels at close to $2 trillion in total. The companies that do have debt have been able to refinance at record-low interest rates.

It appears to be shaping up to be another good year in equities. There is always the risk, of course, that managements make a misstep or that politics intrude in a negative way. When weighed against many other investments, however, equities look very attractive.

Tim Evnin is a Partner and Portfolio Manager at Evercore Wealth Management. He can be contacted at evnin@evercore.com.
**Evercore Wealth Management Hosts Events in New York, Minneapolis, San Francisco**

Three of the Evercore Wealth Management offices hosted events in January and February. The New York and Minneapolis client events considered the outlook for the markets and reviewed the firm’s approach to asset allocation; the San Francisco Continuing Legal Education, or CLE, event focused on industry ethics.

For information on future events, contact springer@evercore.com in New York; Martha Pomerantz in Minneapolis at martha.pomerantz@evercore.com; and Keith McWilliams in San Francisco at keith.mcwilliams@evercore.com.

**John Apruzzese Ranked Among Country’s Top CIOs**

ExecRank named John Apruzzese among the top chief investment officers in the United States.

To view the full list of the 2012 Top CIOs, as determined by ExecRank, as well as ExecRank’s selection process, visit execrank.com/2012/08/chief-investment-officers/.

**Chris Zander Featured in The New York Times**

The Evercore Wealth Management National Head of Strategic Planning, Chris Zander, was interviewed by *The New York Times* on recent changes in tax legislation and related wealth planning strategies.

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