For most private investors, the biggest driver of net returns over the next 10 years should be stocks. Other assets have an important role to play in many portfolios but, with the exception of illiquid alternatives, none seem likely to generate the returns net of taxes, inflation and fees that we expect from publicly traded stocks.

Indeed, the return on stocks may be better than many investment firms realize. Most analysts forecast earnings based entirely on an earlier determination of GDP, an approach that doesn’t allow for the possibility that earnings could perform very differently from GDP. In the United States, the earnings of the S&P 500 constituent companies have been growing at a significantly faster clip than the economy as a whole and look set to continue doing so for at least the next 10 years. In this issue of Independent Thinking, we demonstrate how we calculate our 8.5%, or 4.3% after taxes and inflation, projected 10-year return for the S&P 500 and what that means for individual portfolios.

(continued on page 3)
As we go to press with this issue of *Independent Thinking*, the economic recovery in the United States continues to ripen and our clients are participating in that. We are proud of our strong results and prouder still of our people, who come to work every day thinking of our clients, as Andrew Sibbald, Evercore’s CEO in Europe, writes on page 5, first, second and third.

However, market conditions remain difficult for some investors, notably those who had planned their futures around traditional portfolios of municipal bonds and now find themselves in need of income, as yields remain at near-record lows (and stocks flirt with record highs). We are seeing many new clients come to us eager to find alternative sources of income but still wary of investing heavily in the stock market.

With that in mind, we take a good look in this issue at our return expectations across our range of asset classes and at the role of both growth and defensive assets, including thoroughly researched bonds, in individual portfolios. We also consider some of our other allocations, including those to credit strategies and alternatives, stressing the importance of understanding the associated risk, reward and tax expectations for each – and not blindly searching for yield.

We believe, through long experience, that private investors are best served by staying the course, supported by close relationships with their advisors who are mindful of their circumstances and their long-term goals, as well as their attitudes to risk. It takes constant vigilance to build and manage customized portfolios that can stand the test of time, meeting our clients’ goals through market cycles in both good times and bad.

Our approach to wealth management, coupled with our strong investment performance, has encouraged us as a firm to continue growing, and as of July 1 we hired our 70th employee, welcoming Wealth Advisor Helena Jonassen, who left U.S. Trust after 18 years to rejoin many of her former colleagues at our New York headquarters. Our still-new team in Tampa, which joined us from GenSpring Family Offices and SunTrust, is off to a running start in the Southeast, and our business across the United States continues to thrive.

In short, this is shaping up to be a bright summer at Evercore Wealth Management. We are looking forward to relaunching our public website and one dedicated to clients that will set new standards in technology without sacrificing the human contact that all of us here hold so dear.

We’ll also bring you a redesigned *Independent Thinking*, to better showcase our intellectual capital and that of our Evercore colleagues. More to come on these initiatives and on planned events in the fall. In the interim, please contact any of us at Evercore Wealth Management with any questions or comments you may have; we very much welcome your engagement.

I wish you and your family a healthy and happy summer.

Jeff Maurer
Chief Executive Officer
The expected growth rate of real GDP, which is made up of the growth rate of the labor force plus productivity growth, seems to us the right starting place. The Bureau of Labor Statistics estimates that the labor force will grow at just 0.6% a year over the next 10 years as baby boomers start to drop out of the workforce. Productivity is more difficult to predict, but the Congressional Budget Office’s projection, which seems broadly right, also shows a slight deterioration to 1.6% a year from the prior 10- and 30-year periods. Taken together, these statistics translate into a 2.2% growth rate in real GDP. Factor in the bond market’s expected rate of inflation – also 2.2%, as measured by the 10-year TIPS Breakeven Rate – for the next ten years, and we get to a 4.4% growth rate for nominal GDP.

Many firms, however, don’t take the next step – to consider the relationship between corporate earnings growth and nominal GDP. Over the last 30 years, S&P 500 earnings have grown 2.2 percentage points faster than nominal GDP. The differential reflects the increasing global strength and relatively high rates of return of its constituent companies, among the premier businesses in the world (now with 40% of revenues derived from outside the United States), and the Darwinian nature of the index itself in which inferior companies fall off and superior companies increase their weighting.

This relationship of earnings to GDP seems likely to remain constant over the next 10 years, taking us to a 6.6% growth rate for earnings. We then add the current dividend yield on the S&P 500 (1.9%) to the growth rate of earnings to calculate a total return of 8.5%, or a net return of 4.3% when federal capital gains taxes (at the highest rate) and inflation are factored in. It’s important to note that these expected returns are also net of fees because we expect our investment returns from active management to exceed the general market returns by at least the amount of our management fees.

We can’t rest there, however. There’s one more factor to be considered, and it’s much more of a wild card – investor psychology. How confident investors are about the future and how that sentiment intersects with the variables discussed above will determine how much investors are willing to pay for the current level of earnings and their projected growth rate.

While we have recently entered a period of unusually low volatility, the market is more often than not gyrating because it is constantly changing its level of confidence about the future based on a flood of current economic data, geopolitical events, shifting domestic politics and external surprises such as natural disasters. It is possible that we could get our economic projections exactly right, but the actual rate of return on the market could still vary dramatically due to changes in investor sentiment.

The best measure of investor sentiment is the price/earnings ratio, or P/E ratio, of the S&P 500. The more confident and optimistic investors are about the future, the higher the price relative to earnings. We look at three different P/E ratios to determine where the market
currently stands versus the 30-year average. According to the first of these, trailing earnings over the past 12 months, the market is selling for 17.7 times earnings versus the 30-year average of 21 times. Based on expected earnings for the next 12 months, the market is selling for 15.5 times earnings, up from the long-term average multiple of 14.8. And last, based on the average earnings over the last 10 years, the so-called Schiller P/E registers a multiple of 24.4, compared with the 30-year average of 22.9 times.

Taking all of the above into consideration, we view the market to be very close to the longer-term average valuation, and we do not have any reason to believe the valuation level of the market will vary markedly from the average 10 years from now. That doesn’t mean it won’t vary markedly within that time frame, of course, which is why we constantly review our short- and medium-term tactics in the context of our longer-term expectations. At present, liquid domestic stocks account for about 50% of balanced portfolios at the firm and about 70% of growth portfolios. Additional allocations to illiquid alternatives (for which we have a 15% total 10-year return expectation) increase equity exposure in many portfolios.

Finally, it is worth noting that while our total return forecast for international equity markets is also 8.5%, the reasons are different. We expect nominal GDP growth for global markets except the United States to be higher because of the influence of the emerging markets, but there is no evidence that foreign corporate earnings grow any faster that nominal GDP. In fact, earnings in the emerging markets have grown more slowly than GDP over the last 20 years. The current dividend yield on international stocks is also higher but, because there is no excess earnings growth over GDP growth similar to what we observe in the United States, the expected total return is the same. We also believe that the free flow of capital across the global equity markets should cause long-term returns to converge.

John Apruzzese is the Chief Investment Officer at Evercore Wealth Management. He can be contacted at apruzzese@evercore.com.
Having been through the M&A process ourselves, we know that selling your own firm can be an emotional experience for entrepreneurs as they become part of and, in our case, return to a larger organization. We were fortunate in that we had a really great business, a wonderful culture and were actually really enjoying ourselves when we met (Evercore CEO) Ralph (Schlosstein) here in London and he laid out for us his rather modest goal of creating the world’s leading independent advisory firm.

The scope of that ambition, and our sense that Evercore could really realize it, was naturally a huge attraction for us. But what really clinched it was the cultural fit, which was simply exceptional – from the small things, such as the very similar style of our presentations, to the business fundamentals where both firms really believed in putting clients first, second and third, and delivering to them genuinely independent, high-quality and brave advice.

A wry colleague observed that it can take between two years and never to merge investment banking cultures, but I believe we were one team within a year. From day one, we adopted the Evercore name, we all moved to a new building (in Mayfair), we merged our back offices and other staff, and have subsequently added five teams to our existing industry specializations in financial services, oil and gas, and utilities, which are now part of their global teams. Today, if you ask anyone here, I think they will tell you that they feel part of Evercore and part of the firm’s wider momentum as we strive to achieve our ambition.

The firm expects great things from our business in Europe, although it obviously has some catching up to do compared with the United States, a much larger market that has enjoyed a more active equity and M&A environment for longer since the financial crisis. Indeed, the crisis really impacted the markets here and M&A was slow to recover, but we have seen a strong resurgence recently – especially in the pharmaceutical industry where there has been a series of public bids lately in which Evercore has acted in the defense of both Astra Zeneca and Shire. We now have a more active environment and more supportive markets – and we can see the impact of that in our deal pipelines.

Of course, Europe is far from being a homogenous financial market, and conditions vary a great deal depending on the country. The United Kingdom remains one of the world’s most important financial centers, in terms of global individual and corporate wealth coming to London. We are also seeing a recovery in Germany – and to a lesser extent, France – but there are still deep problems elsewhere. Other European countries really don’t have anything like the liquid markets, professional services, favorable tax environment and language accessibility that we have here in the United Kingdom. And they also have the Euro, which still carries a degree of caution for some investors. The levels of sovereign, corporate and individual debt in Europe, and the need for central banks and Governments to manage the return to growth delicately over time, avoiding the pitfalls of inflation and unemployment, mean that we’re really not out of the woods yet. These issues are no longer on the tip of everyone’s tongue as they were a year ago, but they’re still an underlying concern.

You need to be selective, of course, but there are plenty of opportunities for investors across the region, notably in the financial and infrastructure sectors, in private equity and distressed debt. There are also tax structuring opportunities, especially for U.S. corporates, which have been attracting attention. We still face some headwinds as the markets continue to recover in Europe, but we have excellent industry franchises and strong IPO and M&A capabilities, and we believe there is an enormous opportunity in Europe for us to contribute to a leading global independent advisory business. Evercore may still be the new kid on the block here in London, but that is really changing fast.
Investors in equity retail funds earned just a third of the return generated by the S&P 500 for the 20 years ended 2013. That fault is not with the funds, although many overcharge, but with the investors’ own timing. Retail investors tend to sell stocks on bad news, after the price has dropped, and wait until recovery is well established before buying.

But short-term fluctuations in share prices are not the enemy; inflation is. Volatility declines to zero over time, like the bounce of a tennis ball, but inflation rises. Has a U.S. postage stamp ever cost less? The longer we live, the more vulnerable we are to inflation eroding the value of our financial assets.

By extending the time horizon of their investment thinking, say five years at a minimum, investors can use volatility to their advantage. Stocks can have high volatility over short time periods. Over the last 20 years, annual stock returns have fluctuated from a 51% gain to a 37% loss. But as the time horizon lengthens, the volatility of stocks narrows and ebbs to the positive. Over five-year rolling time periods over the same 20 years, stock returns fluctuated from a positive 28% percent to a negative 2%. Ibbotson Associates’ studies demonstrate a 90% likelihood that stocks will increase in value over five-year time periods. Allocating a sufficient proportion of total assets to defensive holdings, including fixed income and cash, to meet expenses through that period can certainly help investors weather the storm and keep focused on the long-term objectives of their growth holdings, which are the assets more likely to outpace inflation.

Savvy investors can take this approach one step further by anticipating changes, using volatility to their advantage and making tactical adjustments to portfolios when opportunities become available. As Evercore Wealth Management CIO John Apruzzese notes in the cover article of this issue of Independent Thinking, our current expectations for stocks factor in our economic and monetary outlook. We also consider investment sentiment, which has been influenced over the past 30 years by rising bond values as interest rates have declined. This is why many investors continue to view bonds as a safe investment. However, as interest rates rise from near all-time lows, bond prices will come under pressure. Retail investors will likely then shift to equities, although many will wait too long and buy when the biggest gains are already priced into the market. We strive to anticipate these changes.

At Evercore Wealth Management, we work with each client to set an asset allocation that will work for their particular situation over time, making tactical adjustments to asset classes and individual investments based on our analysis of the coming period.

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How much can I spend from my portfolio?” Often, this is the first question posed by investors. The answer depends on each investor’s long-term goals. How long will you need to withdraw these funds? Do you wish to leave a legacy for your heirs or charities? How much do you wish to leave?

One way to think about this is in the context of golf. A good golfer knows that the distance to the hole influences the choice of club. An investment portfolio with a 35-year time frame needs to generate a return in excess of the lifestyle expenses, taxes, fees and inflation to be sustained over that period if he or she wishes to leave anything to heirs or to charity.

Sticking with this metaphor, consider that the first shot off the tee sets up the potential for the second shot. If the long-term goal is to fund lifestyle expenses while also growing the portfolio to pass on to next generations or to charity, the asset allocation over the period must have a growth component that exceeds inflation.

As illustrated in the table at right, an investor with a $10 million tax-exempt fixed income portfolio with an estimated average return of 3.2% net of fees, will see the value of his or her portfolio deplete over 35 years if 3% is withdrawn annually, adjusted for inflation. Conversely, a shorter time horizon can be a benefit, as the impact of inflation on the withdrawals is not as severe for a 15-year period.

For an investor with a balanced portfolio that has a meaningful allocation of growth-oriented assets with an estimated average return of 7%, we believe that the portfolio will continue to compound in excess of the withdrawals for annually inflated lifestyle expenses and taxes. The longer the time horizon, the longer the excess reinvested has time to compound.

Higher portfolio returns generally require a greater proportion of equity assets, driving greater volatility and increasing risk. As Martha Pomerantz writes on page 6, volatility can also provide opportunity for investors with a medium- to long-term horizon. In any situation, individual circumstances must be considered when assessing the appropriate asset allocation and spending amount, with risk tolerance and time horizon as key factors.

Stacie Price is a Partner and Wealth Advisor at Evercore Wealth Management in Minneapolis. She can be contacted at stacie.price@evercore.com.
Daniel P. Davison, a former CEO of U.S. Trust and one of my personal heroes, used to joke that his parents had “left him with nothing but good taste.” As a product of Groton, Yale University and Harvard Law School, however, he knew that he had a running start in life. To his credit, he made the most of it.

Today, Danny's education from eighth grade through graduate school would cost $720,000, starting at $54,000 a year for tuition, room and board at Groton, and progressing to $60,000 a year at Yale and $70,000 a year at Harvard Law. If Danny were born today, we’d have to consider the inflation rate for private education, which averages between 1.5 and two times the general rate. The tuition bill would then total $1.4 million, a number that would give even the most patrician families pause.

Funding a private education is increasingly a family effort. Recent surveys suggest that about two-thirds of parents are saving for their children’s college educations and that about half of all baby boomers plan to contribute to their grandchildren's education. My wife and I, having accomplished the former, are now delighted to find ourselves in the second camp, with, as of last month, the futures of four grandchildren to consider. Even in families that regard education costs as the responsibility of parents, and post-graduate studies the responsibility of the students (and a major source of motivation to earn and save), the grandparents like to know that they are ready and able to contribute if needed.

But how best to do so? 529 plans are a wonderful tool for both parents and grandchildren. Created in 1996 by the IRS, they are operated by state or educational institutions to enable families to set aside funds for future college and graduate school costs by investing in a tax-advantaged way. Investment returns grow tax-deferred and withdrawals are tax-free, provided the funds are used for qualified higher education expenses. (They are otherwise subject to normal income tax rates and a 10% penalty.)

The federal and state income tax rules are complex and merit discussion with a wealth advisor. Contributions to the plan are considered completed gifts to the beneficiary, generally a child or grandchild, and are subject to federal gift, estate and generation-skipping transfer taxes. They are also subject to the same annual exclusions – this year $14,000 per recipient – as other gifts. Contributors are allowed to front-load up to five years of contributions, or $70,000. However, any other gifts made to the same beneficiary over the next five years would be subject to tax or attributed to the donor’s lifetime exclusion. Other significant considerations include deductibility. Married New York state residents, for example, may be able to deduct up to $10,000 a year on their state income tax return.

I would encourage all parents to consider using 529 plans to the best of their ability. That can be a challenge, especially in families with several children and in major metropolitan areas. In New York, private school tuition costs have climbed 79% in the past decade, making grade school
almost as expensive as college. Parents should save what they can and let the funds accumulate tax-free. A contribution of $28,000 per year starting at birth could total close to $1 million in time for college, based on our estimate of pre-tax total return for a balanced asset allocation. That's enough to cover tuition, room and board at college and graduate school — and to allow the parents to shift their focus to their own retirement savings.

Grandparents can also use 529 plans but may consider other options that can also reduce the size of their taxable estates. We can create trusts for our grandchildren and pay the tax on the income during our lifetimes. These trusts can be set up to last for a child's lifetime or to pay out at specific ages, say half at 30 and the remainder at 40, or to cover specific purposes such as buying a house or starting the next Google — or at the trustees' discretion. If we are lucky to live long enough, we could pay private school tuition, college tuition and graduate school tuition free of transfer tax, allowing the trust to be used for other purposes.

It's worth noting that funding an education can be a shared effort. If grandparents cover tuition, the parents’ 529 savings could be used for room and board and other expenses. Excess funds can be transferred to another beneficiary or even be put aside for the next generation.

Payments that qualify for the educational exclusion must be made directly to a qualifying domestic or foreign institution as tuition for the education of an individual. In other words, we could pay a grandchild's college tuition, excluding room and board, in the amount of, say, $40,000, and also give the grandchild an additional $14,000 in the same year without incurring any federal gift tax.

With good planning, we can pay for our children’s and grandchildren’s educations as tax-efficiently as possible, giving them a running start in the hope that they too make the most of it.

Jeff Maurer is the CEO of Evercore Wealth Management (and a former CEO of U.S. Trust). He can be contacted at maurer@evercore.com.
Trusts can play an important role in achieving your family’s long-term objectives. Properly structured, they can protect and control the transfer of wealth, create a charitable legacy, reduce estate taxes, protect children’s inheritances from failed marriages, and even postpone an inheritance until a child is mature enough to handle the responsibility; all typical challenges that may confront an affluent family.

Less typical, but more critical for those affected, is the need of a family to provide for the future of a disabled child or other relative. In many cases, planning for a family member with special needs is the single most pressing – and complicated – financial obligation for that family. Considerations can include:

- How do you leave funds for the benefit of the child or other relative without causing the child to lose important public benefits?
- How do you make sure the funds are well managed?
- How do you make sure that your other children or family members are not overburdened with caring for the disabled sibling and that any burdens fall relatively evenly among all siblings?
- How do you balance your overall estate plan to make sure you provide for your other siblings and implement a coordinated strategy with your broader financial picture?
- How do you find a team of professionals to preserve and protect your relative’s interests after you’re gone?

Special Needs Trusts or Supplemental Needs Trusts offer a unique planning tool that can substantially enhance the lifestyle of individuals with a disability. A special needs trust aims to manage funds to pay for the beneficiary’s unique or special needs. A supplemental needs trust aims to address the limitations of public benefit programs, by preserving the beneficiary’s eligibility for public benefits, including Medicaid Supplemental Security Income. These trusts can help in a range of situations, such as parents planning for a child with a disability, a disabled individual coming into an inheritance or winning or settling a personal injury claim, or one spouse planning for a disabled spouse.

At Evercore Wealth Management and at our affiliate Evercore Trust Company, N.A., we believe that control, compassion and collaboration are the critical factors in successfully administering these trusts. We suggest naming an experienced trustee who can safeguard the assets, employ care and skill in the discretionary decisions to distribute funds, and ensure that the assets are well managed in keeping with the beneficiary’s objectives.

The trustee or trustees must be able to empathize with the beneficiary and the family, demonstrating care and concern, and be objective at all times. It’s important to note that the trustee or trustees must also be able to empower a team of caregivers and professionals to ensure that the beneficiary’s best interests are considered.

Each family’s situation is unique and their set of concerns very personal. Please feel free to contact us with any questions you may have.

Karen Francois is a Partner and Wealth Advisor at Evercore Wealth Management and the Chief Personal Trust Officer at Evercore Trust Company, N.A., a national trust bank with $42.3 billion in assets under administration as of 3/31/2014. She can be contacted at francois@evercore.com.
Defensive Assets
Bond Substitutes: Not the Real Thing
by Brian Pollak

So-called bond substitutes, advocated by some advisors as replacements for traditional high-quality bonds, don’t pass the duck test (does it look like a duck, swim like a duck, and quack like a duck?). These investments, which can include dividend-paying stocks, real estate investment trusts, or REITs, business development corporations, or BDCs, master limited partnerships, or MLPs, long/short hedge funds, short duration high-yield corporate bonds, and leverage loans, may look like bonds – or at least like bonds used to – in generating an attractive yield. But they fail to exhibit the same defensive qualities.

Many of the investments considered bond substitutes have volatility and maximum loss potential that is much closer to broad equity benchmarks than to high-quality bond portfolios. Leveraged loans and short duration high-yield bonds generally have lower volatility and less risk than equities, but are likely to have correlations closer to stocks than they will to bonds. Ultimately, the returns of all of these investments, at some level, will be driven primarily by the prospects of corporations or the growth of the broad economy.

Returns of high-quality bonds are driven by very different factors than these asset classes. The level of prevailing interest rates determines the prices of these securities and, as investors know, bond prices move inversely to bond yields. Conversely, yields fall and bond prices rise with low inflation or weak growth. Over the past 30 years, the prices of bonds have mostly been rising as falling inflation trumped strong growth for most of the period, leading to very strong bond returns and, presently, very low bond yields. Since the beginning of the 1980s, when both bonds and stocks have done well together, the drivers of those returns were very different.

There is a role in many portfolios for these bond substitutes, as long as the associated risks are clearly understood and accounted for. High-quality bond portfolios can suffer losses, and persistent low yields have encouraged us to reduce our exposure to that asset class at the same time that we raised allocations to others. However, we are always mindful of the new risks and potential returns within the context of our overall asset allocation.

For instance, within our allocation to credit strategies, we recommend a mutual fund that invests in leveraged loans (loans of lower credit-quality corporations that mostly float over LIBOR), where the strategy does not take on any interest rate risk, but does take on materially more default, or credit risk, than would a high-quality bond portfolio.

Selected Indices*

<table>
<thead>
<tr>
<th>Index</th>
<th>3Y Volatility</th>
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<tbody>
<tr>
<td>S&amp;P 500 Total Return Index</td>
<td>12.26%</td>
</tr>
<tr>
<td>Alerian MLP Index</td>
<td>13.38%</td>
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<tr>
<td>MSCI U.S. REIT Index</td>
<td>16.41%</td>
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<tr>
<td>S&amp;P BDC Total Return Index</td>
<td>14.59%</td>
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<tr>
<td>Barclays U.S. Aggregate Bond Index</td>
<td>2.77%</td>
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<td>Barclays Municipal Bond Index</td>
<td>3.86%</td>
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*Indices are representative of various “bond substitutes” and broad bond markets

While we do not specifically recommend a REIT portfolio today, we do recommend a global real estate-focused fund that includes some REITs in the portfolio. This investment is part of our allocation to growth assets, as we expect it to have a risk and return profile that is similar to traditional equity investments.

We also employ some long/short hedge fund strategies within our recommended portfolio. We believe when managed by experienced hedge fund managers, such as Joel Greenblatt from Gotham Funds interviewed on page 14, in strategies conducive to liquid formats, these can be effectively deployed in mutual fund form. Those that we recommend fall under our diversified market strategies allocation, in which we are focused on achieving a sustainable attractive absolute return with low correlation to both the equity and bond markets.

We still research, own and manage bonds as the key defensive asset in our portfolios. It’s important to stress that when an equity portfolio is under heavy pressure, say when growth is weak or there is a deflation scare, a high-quality bond portfolio is likely to rise in value, while some other investments could fall quite precipitously. That’s why, while bond substitutes have a place within a portfolio, a defensive bond portfolio remains a critical component of a balanced asset allocation.

Brian Pollak is a Managing Director and Portfolio Manager at Evercore Wealth Management in New York. He can be contacted at pollak@evercore.com.

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As we enter a new hurricane season on the East Coast, delayed maintenance and underinvestment across most of the categories measured by the American Society of Civil Engineers have undermined one of the world’s great cities at its core. Continued failure to maintain the existing infrastructure system – with a cost estimated to be $47 billion – could cause deterioration in the region’s economy and quality of life.

The chart below delineates the major credit characteristics of the primary enterprise agencies in the New York metropolitan area. In short, these issuing entities face myriad challenges, particularly when it comes to addressing their capital needs and the potential financial burden that may be placed on each entity.

The Port Authority of New York and New Jersey has been a vital force in the physical and economic growth of the region. It built the bridges and tunnels that connected the two states and manages a bi-state mass transit system. It has developed and now manages the airports that made the region the nation’s gateway for international air travel. It built the world’s first container port and the world’s busiest bus terminal. It built the World Trade Center – and is now rebuilding it.

It would be difficult to overstate the critical nature of this entity for the economic viability of the region. Yet its very management is being questioned under the seeming politicization of its appointees. This has exposed the Port Authority’s spending, revenue raising and management decisions in the efficient running of its agency operations, and prompted a spate of scrutinizing reports.

There is now broad recognition that the Port Authority (especially in New Jersey) has served as a source of patronage for political appointees, and that there are conflicts within the agency between those who see themselves as serving the interests of either New Jersey or New York, rather than the mutual interests of both. Elected officials of either state should rely on the Executive Director to appoint qualified individuals to high-level positions.

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**Major Entities in Charge of Financing NY Metropolitan Infrastructure Improvements**

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Ratings Moody’s/S&amp;P/Fitch</th>
<th>Operating Revenue ($ Billions)</th>
<th>Debt Outstanding ($ Billions)</th>
<th>Capital Plan ($ Billions)</th>
<th>Debt From Capital Plan ($ Billions)</th>
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<tbody>
<tr>
<td>Port Authority of New York/New Jersey</td>
<td>Aa3/AA-/AA-</td>
<td>$4.1</td>
<td>$21.6</td>
<td>$27.1</td>
<td>$7.9</td>
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<tr>
<td>NYC Municipal Water</td>
<td>Aa2/AA+/AA+</td>
<td>$3.5</td>
<td>$29.5</td>
<td>$12.9</td>
<td>$6.5</td>
</tr>
<tr>
<td>Triborough Bridge and Tunnel Authority</td>
<td>Aa3/AA-/AA-</td>
<td>$1.6</td>
<td>$8.8</td>
<td>$2.1</td>
<td>$1.25-$1.5</td>
</tr>
<tr>
<td>New Jersey Turnpike Authority</td>
<td>A3/A+/A</td>
<td>$1.6</td>
<td>$9.3</td>
<td>$7.0</td>
<td>$2.9</td>
</tr>
<tr>
<td>New York Metropolitan Transportation Authority</td>
<td>A2/A+/A</td>
<td>$13.8</td>
<td>$19.3</td>
<td>$24.2</td>
<td>$10.5</td>
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<tr>
<td>(Rev Debt Only)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New York State Thruway Authority</td>
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<td>$0.7</td>
<td>$5.1</td>
<td>$4.4</td>
<td>$2.2</td>
</tr>
</tbody>
</table>
There has also been some renewed discussion of separating the different parts of the Port Authority into individual self-supporting agencies – in effect, dismantling the Authority. The economics of this proposal won’t work, however, as many of the Authority’s operations lose money and couldn’t survive without hefty subsidies from other parts of the organization. Also at stake is the $21 billion in outstanding Port Authority debt, which is secured by the consolidated enterprises of all of the facilities.

Five other agencies are also facing their own unique set of political and infrastructure challenges. We do feel, however, that the strength of the professional management of these facilities and the economic base supporting these enterprises outweigh these credit challenges.

- **New York Metropolitan Transportation Authority:** Besides its extensive capital plan, the MTA has high fixed costs for labor-related expenses, multiple collective bargaining agreements and assumed labor savings that are just beginning to materialize. In addition, and similar to the Port Authority, there is multilevel government involvement in the financial and capital planning, which adds to management’s challenges.

- **Triborough Bridge and Tunnel Authority:** As an affiliate of the MTA, the TBTA is legally required to subsidize the MTA, thus constraining TBTA’s ability to build up balance sheet liquidity. We also note that Superstorm Sandy significantly affected the Authority’s facilities and operations, particularly for its two tunnels.

- **New York State Thruway Authority:** The debt for the Thruway Authority continues to rise significantly as it addresses the capital needs of this 570-mile system, as well as replacing the Tappan Zee Bridge. There is uncertainty due to the lack of a specific tolling plan, as the Authority will need to embark on a period of frequent toll increases and, consequently, diminishing rate-setting flexibility. A major question continues to be whether the tolls from the new bridge in downstate should provide the bulk of the revenues to cover the capital costs or whether this burden should be spread more evenly over the entire system.

- **New Jersey Turnpike Authority:** The Authority has been able to maneuver through the state’s historically difficult and politically charged rate-setting process to provide stable financial operations. However, there are annual transfers to the state’s underfunded Transportation Trust Fund that limit the ability to improve the Authority’s liquidity. Many toll systems throughout the country are being called upon to subsidize other transportation projects, as traditional sources of subsidies, particularly fuel taxes, continue to decline.

- **New York City Municipal Water Finance Authority:** Even the highest rated entity on this chart faces political pressures in maintaining operations. In addition to a history of state and federal regulatory mandates, mayoral appointees to the City Water Board are aware of the mayor’s agenda concerning the overall approach to taxes and fees and the burdens placed on various constituencies.

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Editor's Note:
Evercore Wealth Management complements its core investment capabilities with carefully selected external advisors to generate the highest after-fee, after-tax, risk-adjusted returns. Here we interview Joel Greenblatt, managing principal and co-chief investment officer of Gotham Asset Management. The Gotham Funds are a series of long/short equity hedge funds available in mutual fund form: the Gotham Absolute Return Fund (GARIX); the Gotham Enhanced Return Fund (GENIX); and the Gotham Neutral Fund (GONIX).

Q: You started your career managing concentrated stock portfolios in hedge fund form. Why have you transitioned to include a more diversified mutual fund strategy?

A: Concentrated portfolios achieved high returns but also had very high volatility. We believe that the approach we use now, which utilizes the same valuation principles, can produce very attractive returns but with less volatility. We think that, for the majority of our investors, employing strategies with less volatility will help them feel comfortable with a longer-term investment approach, which will help them stay with the strategy over the long run.

Q: Gotham has three different mutual funds. Please describe each of the strategies, their commonalities and differences. How should investors use and think about each fund?

A: Gotham applies the same investment philosophy and process across our three mutual funds and our private fund strategies. We follow a systematic process of researching and valuing companies, investing in our long and short portfolios based on our valuations, and adjusting positions daily to take advantage of changing stock prices and fundamental information. We do not plan to change this strategy or adopt other methodologies when short-term stock prices do not reflect the values that we see.

Our stock positions, which generally include over 300 names on both the long and short sides, are not equally weighted. Generally, the cheaper a company appears to us, the larger allocation it receives on the long side. On the short side, the more expensive a company appears relative to our assessment of value, the larger short allocation it receives. We manage our risks by requiring substantial portfolio diversification, setting maximum limits for sector concentration, and maintaining overall gross and net exposures within carefully defined ranges.

Our three portfolios offer different exposure levels for varying investor needs. We believe that GENIX (170% long, 70% short) is a better way to be 100% long, GARIX (120% long, 60% short) can provide a source of absolute return to investors. GONIX (market neutral) seeks to offer capital appreciation with minimal correlation to stocks or bonds.
Gotham Asset Management
An Interview with Joel Greenblatt

Q: What makes the Gotham Funds different from other liquid alternative products?
A: The Gotham Funds are undiluted hedge fund strategies available in a mutual fund structure. We have the ability to offer mutual funds that mirror our hedge fund strategies because our private funds are very liquid and offer similar fees. Generally, it would be difficult for private funds that charge, for example, 2% on assets under management and 20% on performance, to offer an undiluted strategy and lower fees to a mutual fund.

The funds utilize bottom-up fundamental analysis and offer investors exposure to equities through a very diversified approach of over 300 positions. In addition, to obtain their short exposure, the funds take single name equity positions, not ETFs.

Q: How do you describe the process used to evaluate both the long and short positions within the portfolio?
A: To determine the value of a company, we do not merely rely on its reported numbers. Our team of analysts reviews the balance sheets, income statements, cash flow statements and other financial data of 2,000 large- and mid-cap U.S. companies. We analyze this information to reflect our views of economic reality for each company and consistently update this proprietary research for all companies in our coverage universe. Our positions are not equally weighted. Generally, the cheaper a company appears to us, the larger allocation it receives on the long side. On the short side, the more expensive a company appears relative to our assessment of value, the larger short allocation it receives.

Q: How are you able to cover so many stocks from an analytical perspective?
A: Our valuation methodology and investing principles do not change over time, which makes our process consistent and repeatable.

Q: What types of markets are ideal for the success of this strategy?
A: All of our portfolios are designed and then constructed to provide two potential sources of investment return: a long only component and a long/short component. In GARIX (120% long, 60% short), for example, the first potential source of returns is from the $60 investment in the stocks we feel are the cheapest. Our second potential source of profits is the spread between how much an additional investment of $60 in our long stock selections returns versus the returns of $60 of our short selections. We believe that our long/short-spread returns will be largely uncorrelated with the market’s returns in many environments.

Q: Can you explain why your spread returns are not correlated to the market?
A: How much our long selections outperform our short selections should have little to do with general market movements. In fact, since we believe most of our shorts are highly priced, with many eating through cash or achieving poor returns on capital, we hope and expect that our long/short spreads will actually be even more robust during poor market periods. This, we hope, will significantly help our spreads and add to overall returns in down markets, helping to counteract our long portfolio returns exactly when we may need it most.
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