When asked what he did in winter, the great American ballplayer and coach Rogers Hornsby replied that he stared out the window and waited for spring. For private investors and their advisors, integrating major charitable giving into investment and financial planning should be a year-round practice, drawing on a range of disciplines to create a sustainable strategy.

Private investors give generously – 95% of high net worth Americans give to charity, accounting for about 70% of total giving – but many do so without factoring in timing and structural considerations that could substantially impact the results of their giving on both their personal financial plans and beneficiaries. Many delay tactical philanthropic decisions through the spring, summer and even the fall, and find themselves rushing to meet the year-end deadline for deductions (the charitably minded investor’s equivalent of staring out the window). Others anchor decisions to one-off events, such as the sale of a business or their planned retirement year. It’s far better to plan now, for several reasons.

(continued on page 3)
Spring is always welcome, of course, but this one seems to us particularly bright. There’s a lot going on this season here at Evercore Wealth Management, and I’m happy to report that the firm – your firm – is doing well.

On April 9, we established our first office in Florida and welcomed three experienced planning and investment professionals as new partners to serve clients throughout the Southeast. We now have offices in New York, San Francisco, Minneapolis, Los Angeles and Tampa, managing over $5 billion for individuals, families and related institutions across the United States.

A five-year record of superior performance supports this growth, as we report solid results across our business, both against industry benchmarks and in meeting our clients’ goals. I am delighted that our clients are rewarded for their continued confidence and support.

It’s also worth noting that Evercore Wealth Management is a solid contributor to Evercore earnings, just as we envisaged at inception five years ago. As anticipated, Evercore has recognized the progress of its wealth management unit by raising its ownership stake from 51% to 61%. In five years, Evercore has another option to increase its ownership to 75%. The Partners at Evercore Wealth Management plan to permanently retain our ownership goal of 25%, and continue growing our firm while remaining structurally aligned with the interests of our clients.

We are excited about a number of Independent Thinking panel series events this season, including a conversation with venture philanthropist Jacqueline Novogratz, the founder and CEO of Acumen Fund, on May 5 in New York, a Wise Women Luncheon on May 22 in San Francisco, and a Thoughtful Giving seminar on May 27 in Minneapolis.

Other spring and summer events are in the works, in the wake of successful recent discussions on Thoughtful Giving and, in conjunction with the New York City Chapter of the Alzheimer’s Association, the medical and planning issues surrounding a disease that affects so many families. (For those of us no longer in the springtime of our lives, I write about some of the wealth management issues relating to Alzheimer’s in my regular Aging Baby Boomers column here on page 6).

Soon you’ll be able to see details of these and other events on our new client website. In the interim, please contact your advisor or any of us here at Evercore Wealth Management for further information or with any suggestions you may have for future issues of Independent Thinking and related events. We are proud to serve you and your family, and we welcome your engagement.

Jeff Maurer
Chief Executive Officer
To start, it is very difficult for any investor to make an informed and sustainable long-term decision in a compressed time frame. Charitably minded investors need to evaluate first if there is sufficient capital (current and future) to satisfy individual and family financial goals – across lifestyle, retirement, new business ventures and legacy – to ascertain the magnitude of their desired multiyear charitable giving plan. Determining the best conduit vehicle for giving, whether a donor-advised fund or private family foundation, possibly in conjunction with different variations of charitable split-interest trusts, can be a key factor in facilitating action (see the checklist on page 4) while the ultimate charitable beneficiaries are still being evaluated.

A delay can also affect both the actual value of the donation and the associated tax benefits. After any sustained period of market gains, such as the 140% gain in the S&P 500 index over the past five years, investors should rebalance their portfolio. However, the actual rebalancing can be more effective if it incorporates the investor’s philanthropic plan.

We all are aware that funding charitable giving with an appreciated asset generally makes more sense than giving cash. But we don’t always think of using the appreciated asset in the context of rebalancing, whether a concentrated holding or a discrete portfolio of long-term qualified appreciated stocks or mutual funds that are now overweight in their long-term asset allocation.

Think about it this way: A $250,000 gift of appreciated stock that was purchased years ago for $50,000 allows the investor to avoid approximately $47,600 in federal capital gains tax (assuming a 20% federal long-term capital gains tax rate plus the 3.8% Medicare surtax on net investment income). For New York or California residents, it may save an additional $25,000 in state and local income taxes. Investors can then rebalance to their asset allocation target in a much more tax-efficient way than simply selling a winner, and the income tax deduction that they receive from the gift will generate additional tax savings elsewhere. For example, that $250,000 charitable income tax deduction could save upward of $100,000 in taxes for an investor with a marginal 40% tax rate (subject to limitations described below).

Please note that gifts of appreciated stock to a public charity (including a donor-advised fund) are subject to a deduction limitation of 30% of the donor’s adjusted gross income, or AGI, while similar gifts to a private foundation are limited to 20% of the donor’s AGI. Any unused deduction in the year of the gift can be carried forward for five additional years, so giving slightly too much in a year where there are numerous opportunities to diversify does not necessarily result in a complete loss of the deduction.

Other charitable trusts may be incorporated into the long-term philanthropic plan, depending on the investor’s goals. For those who are looking to diversify a concentrated position in a tax-efficient manner but would like an income stream (either for a period of years or for their lifetime), a charitable remainder trust, or CRT, can be established to meet these objectives and leave the balance remaining to a designated charity or family foundation. While the annual CRT payments are taxable to the recipient, the return on the assets remaining in the CRT is generally tax-exempt. Charitable lead trusts, or CLTs, on the other hand, are taxable trusts that allow for a payment to charity each year, with the remainder passing eventually to family beneficiaries. The success of a CLT is driven largely by the trust’s investment returns, especially in the current low interest rate environment. At a minimum, the return needs to exceed the Internal Revenue Code Section 7520 rate, currently 2.2% for trusts established in April 2014. The trust can then effectively pass additional assets to the family while also benefiting a charity in the intervening period. While not conducive to diversifying a concentrated or appreciated position, it is advisable to coordinate the annual charitable payments with a multiyear philanthropic plan as well, especially if that recipient is the investor’s own private foundation or donor-advised fund.
Integration and long-term planning is the key: Each of these elements must work together to achieve the best results for both the donor and the beneficiaries.

At Evercore Wealth Management, this personal, integrated wealth planning strategy is core to our approach to wealth management. Our multidisciplinary teams – which include experts in investment management, tax, financial and estate planning, and in philanthropic strategy – work closely with our clients, their families, and their other trusted advisors to develop, implement and monitor customized wealth plans and investment portfolios.

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**Spring Training Checklist**

An integrated giving plan should include the following:

- An outline of your philanthropic plan for the next five to 10 years that includes a review of your sustainable capital allocation to charity, a summary of existing charitable commitments and pledges, and a summary of outstanding charitable goals.
- A reasonable forecast of your projected taxable income for the year and the next five years, to identify an optimal amount of charitable gifts from an income tax point of view.
- The integration of your investment decisions, throughout the year, with your tax and philanthropic plan to minimize or avoid capital gains tax.
- A time line and evaluation of conduit vehicles (such as a donor-advised fund or a private foundation) in conjunction with other charitable split-interest trusts. This can allow you to separate the investment and the tax-related decisions from the choice of recipient, which can be made later, once your ultimate philanthropic beneficiaries are determined. It will also allow you to select the most effective entity through which to manage your multi-generational giving plan.
- An evaluation process to measure the impact and effectiveness of the plan, including checkpoints on progress as personal financial situations evolve.
Technology companies come to market in waves that rise on sea-changes in the industry. We are seeing that sort of change now, as the market segregates into two distinct groups: the legacy companies that are judged by investors on cash flow and are saddled with relatively low share price to earnings multiples; and the more nimble companies, with high multiples, that can pay ever higher prices to grow and defend their businesses.

The big, slow companies used to have the ability to gain synergy and to scale. But in the current mergers and acquisitions market, they are operating at a real disadvantage. Investors value companies like IBM on a quarter-by-quarter basis. While I certainly wouldn’t call Oracle, SAP, Hewlett Packard or EMC – the mainstays of the tech industry – dramatically overvalued, the market does value them on a quarter-by-quarter basis while investors consider the prospects of fresh IPOs over a 20-year time span.

Look at Amazon. It competes in the Cloud with the big veterans, as well as with Google, but it doesn’t actually make money, so it can continue to grow like crazy. That’s why it’s four or five times bigger than its older rivals. Will that stay the case? Probably not. The majority of Amazon’s business comes from small applications instead of a big channel – it is effectively a low-end grocer, while the high end is still up for grabs. However, barriers to entry here are high, so change may be long in coming.

Everything in the mobile market is up for grabs right now, however. How many devices do you have? It’s changing all the time. Apple and Sony are consumer companies; the real warriors are the arms merchants like Qualcomm. Nothing says that the consumer companies, no matter how great they may seem today, will last forever. In the end-point mobile market, a company can miss just one product lifecycle and die. That’s what happened with BlackBerry: They missed the Apple-like user interface without a competing operating system – and that was it.

Individual investors in this business should focus on the great companies with long-term product cycles. They shouldn’t jump to participate in individual IPOs (although there seems to be a strong case for buying every IPO in the technology sector, as they have outperformed the S&P 500 index in aggregate). More than half of tech IPOs will break issue, or trade below their offer price, within one year. That’s not as alarming as it sounds – almost as high a proportion of the largest companies in the broader market did the same after their own IPOs. But it does mean that there could be later opportunities to buy.

If at all possible, ignore the headlines. Facebook’s defensive plays at ever higher record prices may be the stuff of dreams for a start-up looking for an exit strategy, but it has little impact on the market as a whole.

In technology, even more than in most other businesses, the really great companies of any size will do really, really well. These companies have passionate management, fired-up teams, committed boards and strong financial controls. The others will struggle in an increasingly consolidated market.
Wealth Planning
Aging Baby Boomers: Defending Our Future Selves
by Jeff Maurer

We all pride ourselves on measuring and managing the risks in our lives. As the chief executive of a firm that strives to help our clients achieve their goals by investing their assets, it is my job to manage risk. As a husband, father, grandfather and happily, still, a son, it’s also my privilege to manage risk on behalf of my family. But my focus here is managing the deeply personal risks that we all share – those to our aging selves.

At 66 years old, I know the odds. All told, 13% of people age 65 and nearly half of people age 85 and older have Alzheimer’s disease. We are making great strides in understanding the disease, as Dr. Richard Mayeux, co-director of the Taub Institute for Research on Alzheimer’s and the Aging Brain at Columbia University, told clients of the firm on April 9 at the Independent Thinking panel event titled Understanding Alzheimer’s & Planning for Its Consequences, and sponsored by Evercore Wealth Management and the New York City Chapter of the Alzheimer’s Association. However, there’s no cure on the horizon. I’ll leave the science to him and stick to my knitting, which is wealth management.

What happens when we cannot make decisions for ourselves due to Alzheimer’s or other forms of cognitive dementia, or a sudden illness or tragic accident? How can we protect ourselves and feel confident that our personal and financial affairs will be managed in keeping with our wishes? I’m sharp enough to know that I may not be as sharp in the future and, without the proper safeguards in place, could be misunderstood or, far worse, taken advantage of by caregivers, other acquaintances and perhaps even by my advisors. And I’m old enough to know how important that security will be. As Robert Frost said, “The afternoon knows what the morning never suspected.”

Consider Brooke Astor, the poster elder of financial abuse. As we all know, the philanthropist was financially abused by her son and her attorney – abuse that could have been prevented with better planning when she was in her prime. In the movie Nebraska, the character Woody Grant, as played by Bruce Dern, takes us on a tortured road trip across Middle America, convinced that he has won $1 million in a magazine sweepstakes game, as he desperately seeks to leave a legacy to his sons. My own grandfather, in his 90s, was always after a stock tip to make the big kill.

It’s heartbreaking to think how vulnerable they all were – and how vulnerable still many more are now. One out of five Americans over 65 have fallen prey to some kind of financial abuse, according to a recent survey conducted for Investor Protection Trust. The real number is likely to be even greater, as many victims are either unaware or ashamed to report these crimes.

You would think that the amount of wealth we have would affect our exposure to predators and influence our protections. But that doesn’t seem to be the case, according to the MetLife Mature Market Institute’s 2009 study on elder financial abuse. Certainly, resources improperly deployed offer little protection.

My recommendations for building a system for yourself and your loved ones to prevent elder financial abuse are:

• Set goals – Develop a clear vision for your long-term financial planning, including how your affairs should be managed in case of an unknown event. This will
serve as the foundation for improving communication with your advisors and your family.

• **Select a team of advisors** – Choose your advisors carefully: lawyer, accountant, wealth advisor, and trustee. Share information with them so they can be part of your team. Do not rely on only one advisor. A team provides some safeguards against one advisor making mistakes, or even worse, acting in bad faith. Consider asking your primary care physician to be part of your team by sharing your concerns and asking him or her to evaluate you periodically for cognitive impairment.

• **Talk with your family members** – If you are fortunate enough to have a close family, sharing financial information is important. If you have more than one child, sharing information with only one member or giving authority to only one member can produce adverse effects on family relationships and could also lead to potential financial abuse. Sharing information and responsibility can build long-lasting family ties or can raise issues immediately, rather than after your life.

• **Draft a revocable or living trust** – A revocable trust is an effective vehicle for anyone concerned about their ability or desire to manage their affairs over the years. Choosing a trust company as a co-trustee to serve with family members or other trusted advisors provides an institution with resources to protect your assets. The trust company does not necessarily have to manage those assets or act when you set up the vehicle, but it can become an active co-trustee when a future medical or similar event occurs.

• **Organize your financial data** – It is prudent to prepare a financial net worth summary with underlying details at least once per year.

• **Protect your digital privacy** – In this day and age, it is also vital to protect your digital assets and access to your financial information. Develop a security plan to ensure that only a limited number of trusted family members or close advisors could locate this key information in the event of your incapacity or death.

• **Establish a health care proxy** – Although most of us have health care proxies, we may not have made our wishes clear to our agent, usually a family member, as to when and how they should exercise that proxy. Make your wishes known.

In short, self-defense is the best defense, for as long as we know our own mind. It’s our responsibility to be strong, to protect ourselves from the risks associated with the probable mental frailties ahead and the possible abuses. We will enjoy our golden years all the more if we know that we are prepared.

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Wealth Planning
Thoughtful Giving
by Jewelle Bickford

In the last edition of Independent Thinking, Evercore CEO Ralph Schlosstein touched on the challenges inherent in giving to children, noting that everyone who has achieved some degree of financial success has struggled with balancing what they want to provide to their kids and how hard they want them to struggle.

He is not alone in contemplating this important topic. Many surveys of giving trends among high net worth individuals and families show that the issues associated with giving money to children and grandchildren top the lists of concerns for both men and women.

On one hand, we know that the desire for every generation to earn its own wealth is strongly embedded in American culture. We have all seen evidence that giving too much to children and grandchildren can breed a corrosive sense of entitlement, as well as undermine their confidence and their motivation to work. For many parents, providing a fine education and other enriching experiences to their children as they grow seems sufficient.

On the other hand, it seems that this generation of young people might be the first in the history of the United States to earn less than their parents. If that turns out to be the case, shouldn’t we be using our assets to advantage our children and grandchildren in some way? After all, enabling our children to live better is the main reason many of us worked so hard in the first place.

The Thoughtful Giving program at Evercore Wealth Management engages clients in discussions with their peers. Deciding if, when, and how to raise the topic of wealth in a family, and to give to children and grandchildren, are deeply personal decisions but ones that we can help inform and test first in conversation with others confronting similar challenges.

Communication and financial education are key components of this program. Families can find it very challenging to talk about wealth, especially those of us who were not raised to discuss money. And many, if not most, adult children are unprepared to accept assistance. To become successful inheritors of wealth, they need to become financially literate, to learn to ask the right questions, and to know whom to trust.

In my family, we choose to support our children’s entrepreneurship while trying not to discourage them from taking risks and making those important decisions about their businesses that are essential for success. We do not want to be specific about amounts they will inherit, in case we need the money in our lifetime.

We all hope that our children develop independence and resiliency. Warren Buffet said some time ago that he “wanted to leave my children enough money so they could do something but not so much that they could do nothing.” Deciding just how much that is, and when and how to make that gift, are key to finding that balance.

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Spring Estate and Gift Tax Changes in New York, Minnesota

by Chris Zander and Julie Krieger

Recent tax changes in New York and Minnesota are more complex than they might seem at first read. Here is a brief look at the potential impact to local investors. Please contact your wealth advisor to discuss the changes in the context of your estate and trust plan.

New York

Governor Andrew Cuomo’s Executive Budget for 2014-2015 included a series of changes to New York’s gift and estate tax regime, as well as to the income taxation of certain trusts. Effective April 1, 2014, the new law essentially created a so-called cliff, resulting in an estate tax increase to families whose estates rise above the current New York basic exclusion amount (see below), with no estate tax due for those with estates valued below the current exclusion amount. For large estates already well in excess of the exclusion amount, the New York estate tax will remain about the same.

Highlights

- The New York basic exclusion amount is now $2.0625 million, up from $1 million prior to April 1, 2014. That will gradually increase to come into line with the federal estate tax exemption (currently $5.34 million but adjusted annually for inflation) by 2019. This represents a savings for New York residents with estates at or below the new exclusion amounts.
- However, if a New York taxable estate is valued at more than 105% of the New York basic exclusion amount for that year, then the entire taxable estate is subject to New York estate tax – not just the portion above the exclusion amount. (This is why the change is referred to as a cliff.) The exclusion is also partially reduced if the estate value falls between 100% and 105% of the exclusion amount.
- Gifts made by a New York resident within three years of a decedent’s death will now be added back and subject to New York estate tax. However, gifts made before April 1, 2014, after December 31, 2018, or when the decedent was a non-resident of New York, are exempt from the add-back requirement. This presents a near-term potential estate tax increase.
- It’s important to note that New York does not have a portability provision for the exclusion amount. That’s in contrast to federal law, which allows the surviving spouse to utilize the deceased spouse’s unused exclusion.
- New York has changed its income tax treatment for certain trusts created by New Yorkers who had structured the trusts to avoid New York income tax. Under prior law, a trust would not be subject to New York income tax if all the trustees were domiciled outside New York, the entire corpus of the trust was outside New York, and there was no income or gains derived from or connected to sources within New York. The new law will tax a New York beneficiary with any income received from this type of trust. Also, incomplete non-grantor trusts, typically set up with a Delaware or Nevada situs, will now be treated as grantor trusts for New York income tax purposes and taxed back to the grantor. There is a grace period to unwind these trusts favorably prior to June 1, 2014.

Minnesota

On the heels of a projected Minnesota budget surplus, the state legislature retroactively repealed the 2013 law that created a gift tax effective for gifts made after June 30, 2013. There is also an increase in the Minnesota estate tax exemption, although it is still significantly below the federal exemption.

Highlights

- The state estate tax exemption will increase by $200,000 each year over the next five years, reaching its maximum of $2 million in 2018.
- The Minnesota estate tax rates were modified to begin at a higher rate of 9% on amounts over $1.2 million and increase to the current maximum rate of 16%.
- Minnesota legislation now includes in a decedent’s taxable estate gifts above the annual exclusion amount made within three years of death.
- As a consequence of these changes, a flexible plan with federal portability may be more appealing now to high net worth investors.

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Diversified Market Strategies
The Value of Uncorrelated Returns

by Brian Pollak

Why do we want uncorrelated returns in our portfolios? The main reason – that uncorrelated return streams improve risk-adjusted returns – sounds good. But what does it really mean? We try to answer that here and define some of the most commonly associated terms.

Risk-adjusted returns measure the return of a portfolio against the amount of risk taken to attain those returns. The most common measurement of risk-adjusted return is the Sharpe Ratio, a measurement that subtracts the risk-free rate from the return of an asset, and then divides the difference by the standard deviation of that asset, as illustrated by the formula below.

\[
\frac{\tilde{r}_p - r_f}{\sigma_p}
\]

Where:
\( \tilde{r}_p \) = Expected portfolio return
\( r_f \) = Risk free rate
\( \sigma_p \) = Portfolio standard deviation

In short, the Sharpe Ratio tells an investor if the manager achieved the investment’s return by employing shrewd portfolio management or by taking on excessive risk. Implicitly, a higher Sharpe Ratio is preferable, as it implies the portfolio manager is achieving more return per unit of risk.

If we believe in the concept of risk-adjusted returns, then it follows that we should want better risk-adjusted returns for a portfolio. This is where uncorrelated return streams come into play. Evidence suggests, as shown in the chart below, that the risk-adjusted returns of a portfolio of 60% stocks and 40% bonds can be improved with the inclusion of assets with lower correlations, even when these new assets have the same expected return and standard deviation of the underlying 60%/40% portfolio.

How does that work? Since the assets with low correlation will theoretically not decline over the same time periods as the standard 60%/40% portfolio, their inclusion will lower the underlying volatility (as measured by standard deviation) of the portfolio that includes these uncorrelated assets. As we learned above, assuming the returns are the same, a lower standard deviation will cause the Sharpe Ratio to rise – which, again, is a good thing.

At Evercore Wealth Management, we believe that attempting to improve risk-adjusted returns through uncorrelated assets is worthwhile in an environment where we believe equity valuations are becoming more stretched and where bond yields remain close to historic low levels. The Diversified Market Strategies, or DMS, portion of our asset allocation strives to reduce the overall volatility of a balanced portfolio by adding assets that have historically low or negative correlations to both equity indices and interest rate sensitive bond portfolios. We currently recommend that between 8% and 12% of each investment portfolio be allocated to this strategy, where appropriate.

Seeking to improve the Sharpe Ratio of a given portfolio, the DMS strategy invests in a basket of low-correlation assets. The challenge here is to find managers who are not achieving their returns primarily as a result of broader market moves and who also offer their strategies in liquid vehicles. More often than not, managers with attractive historical performance streams have either been taking...
Low Correlations Matter

Effect of adding assets with identical return and volatility, but different correlations (January 1994 - June 2011)

Source: AQR, Dow Jones Credit Suisse, Hedge Fund Research Inc.
Note: 60/40 portfolio is 60% MSCI All Countries World Index (ACWI) and 40% Barclays Global Aggregate Bond Index. The 0.8 correlated asset is the HFRI Equity Hedge Index, the 0.4 correlated asset is the DJCS Convertible Arbitrage Index, and the 0.0 correlated asset is the DJCS Managed Futures Index. Each of these indexes is scaled to the same return and volatility as the 60/40 portfolio.

on equity risk, credit risk (which is essentially a lower volatility version of equity risk) or interest rate risk to achieve their returns. As we assess managers who fit into this uncorrelated space, we attempt to strip out any performance attributable to broader market beta in order to determine both how much alpha the manager has been able to generate in the past and how consistently they have been able to achieve that alpha. We look for managers who consistently generate positive alpha in a strategy that takes limited market risk. These are a good fit for our allocation.

New to our carefully selected list of external managers is the Gotham Neutral Fund, a market-neutral long/short equity mutual fund. It parrots a very successful hedge fund strategy that has demonstrated low correlation to equity and bond markets and superior risk-adjusted returns since its inception in 2009. We believe this strategy and others like it can help make DMS a valuable component of our clients’ balanced portfolios.

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Defining Risk and Return

Correlation – a statistical measure of how two securities move in relation to each other. Two securities or portfolios that have a 1.0 correlation consistently move together. Two portfolios that have a 0.0 correlation have no correlation or the movements of their underlying securities are completely random.

Standard Deviation – the dispersion of a set of data from its mean. When applied to the annual rate of return of an investment, it measures the investment’s volatility.

Beta – A measure of the volatility, or systematic risk, or a security or a portfolio in comparison to the market as a whole.

Alpha – The excess return of a fund or strategy relative to the return of the strategy’s benchmark index.
It has become a Wall Street tradition for stock market strategists to make predictions of the year-end prices for market indices. Predictions can vary widely, but year in and year out, the average predicted return for the forthcoming year is about 9%-10%, which happens to be about the long-term annual average total return for the U.S. stock market.

While these predictions can be exciting, entertaining and at times, amusing, at Evercore Wealth Management we don’t find them all that helpful when allocating our clients’ assets. For example, since 1926 the long-term total return for the S&P 500 is about 10%; however, only two of the 88 years produced returns in the 9%-11% range. Stocks, not unlike the weather, rarely hit the averages.

We prefer to define our outlook for the U.S. stock market on a company-by-company basis. We invest in durable businesses with capable management teams that allocate cash to projects that will allow them to generate even more cash for years to come. Once identified, we invest with a keen eye to the initial price we pay for the stock.

Viewing the entire U.S. stock market as many individual businesses, rather than as a whole, allows us to focus on the business models and management teams that seem to us the most attractive and that can compound our clients’ capital at a rate in excess of the market averages.

Focusing on individual companies can at times lead us to over- or underweight economic sectors. While we are conscious of the sector allocation of client equity portfolios, it takes a back seat to the individual stock company analysis that our portfolio managers do. This allows us to differentiate from the broad index and to concentrate client portfolios in select securities that we believe have above-average return potential.

An example of a recent addition to our core equity portfolio is Fastenal Company. Fastenal is a leading U.S. distributor of industrial and construction supplies, including threaded fasteners, such as nuts and bolts. Compared with other distribution businesses, Fastenal has very attractive financial metrics, with operating margins and return on assets both exceeding 20%. The company has achieved these returns by developing and maintaining sticky customer relationships throughout its 2,700-store retail network. We consider the management team to be the best that we know in the industrial distribution industry. They have continually found ways to attract new clients, deepen relationships with existing clients, and take share from competitors in this highly fragmented market.

Slowing sales growth in 2013 due to underperformance in non-residential construction and heavy manufacturing customers caused a drop in the share price. The correction allowed us to buy into this high-quality business at a discount to its historical valuation and our estimate of intrinsic value. We expect the share price decline to be temporary, as targeted sales personnel investment and recoveries in the construction and manufacturing markets drive accelerated growth in 2014 and beyond.

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EDITOR’S NOTE:

The Third Avenue Real Estate Value Fund (TAREX) takes the same approach to investing as the other funds in the Third Avenue stable: it’s all about value – in this case a bottom-up, opportunistic approach to investing in real estate and real estate-related companies around the globe. Here we interview Michael Winer, one of the three managers of the fund, which has been carefully selected by Evercore Wealth Management to supplement the firm’s core investment capabilities.

Q: Why did Third Avenue start a dedicated fund in the real estate sector?
A: Third Avenue Value Fund, Third Avenue’s flagship fund, was making significant investments in real estate and real estate-related companies long before REIT funds were in vogue. Our investment philosophy is centered on buying securities at a significant discount to their readily ascertainable net asset value. Applying these principles to real estate securities is much easier than applying them to the large majority of industries.

Q: What about real estate makes it a particularly attractive investment today?
A: Over the long term, we think that the real estate sector has proven through its track record to be an attractive asset class for investors seeking to diversify their overall portfolios and add a level of income to the portfolio. Also, it can potentially act as inflation protection or a hedge. Going forward, however, given the substantial appreciation seen in most real estate securities post-financial crisis, investors will need to be more selective about their real estate exposure to achieve adequate risk-adjusted returns. Over the next few years, it will be imperative to invest in securities that are not as widely held and that are more likely to exhibit inefficient pricing. There are certain pockets of the real estate universe that are likely to prosper in the years ahead, even in a rising rate environment.

These include companies with strong ties to the U.S. residential market, which is still in the middle stages of recovery. Real estate companies with development opportunities in highly desirable markets also should be an attractive segment of the industry, as companies with a development focus have been generally out of favor due to the uncertainty of the economy. We are quite keen on M&A prospects for smaller and mid-size real estate businesses that are viewed as strategic platforms. And, finally, we constantly look for special situations and opportunities in areas where we can provide equity into companies to strengthen their balance sheets at significant discounts to net asset value.
Q: Third Avenue is known as a value investor. What does that mean to you, and how does it impact your philosophy in investing in real estate?

A: Investing in real estate securities – at least the way we do it – is probably the purest form of value investing. As opposed to most sector funds, we do not focus on relative value. And, unlike most other real estate funds, we do not invest based upon dividend yields, cash flow multiples, or attempt to predict which property type or region is going to outperform over the next quarter.

Instead, we employ Third Avenue’s value approach to investing in publicly traded securities and apply it to the global real estate universe. If the fund is investing in the common stock of a property company, it should be purchased at a price that represents a discount to its readily ascertainable net asset value. In addition, the issuer must be very well capitalized, managed by a competent control group that preferably has some skin in the game, and be in a position to increase the net asset value of the company, on a per-share basis, by 10% or more per year after adding back dividends. Last, the company must have adequate disclosures and be listed on an exchange where security holders have appropriate protection.

Q: When most people invest in real estate in the public equity markets, they think of Real Estate Investment Trusts, or REITS, but U.S. REITS are a small percentage of the fund. What kinds of non-REITS does the fund invest in, and why?

A: Given our focus on generating tax-efficient total return, our primary return objective is to generate capital appreciation over current income. Real estate companies are typically structured as either as REITS or as real estate operating companies, or REOCs, which are basically real estate companies structured as taxable C corporations. As our goal is long-term capital appreciation, we prefer the structure of REOCs, primarily because they are not required to pay out dividends. REOCs are able to retain surplus cash and reinvest in their businesses. That being said, we do invest in REITs that we believe offer shareholders a true value.

The fund can also invest in land developers, homebuilders, real estate services providers, finance companies and companies with substantial real estate holdings, like retailers and timber companies. Almost all of these subsectors within the real estate securities market are structured as real estate operating companies.

Q: How does the specter of rising U.S. interest rates affect public equities in the real estate sector? Does it impact the types of investments made in the fund?

A: A sharp jump in rates for the wrong reasons probably will not be good for any asset class, but real estate appears to be as good a place as any, given its tangible asset backing and inflation protection. Assuming interest rates rise for the right reasons, we have identified ways to protect both our portfolio and benefit.

With real estate securities, we believe there are three broad ways to protect capital in a rising interest rate environment. First, investors generally need to avoid stocks favored by income seekers, particularly pass-through vehicles such as real estate investment trusts that offer minimal value creation. Second, investors should maintain a portfolio of well-financed and undervalued common stocks with corporate
initiatives in place to unlock the value. Third, investors should focus investment efforts on companies with shorter duration cash flow profiles like short-term leases and inflation-protected cash flows, as well as investing in companies with assets in high-barrier-to-entry markets that should experience pricing power due to their asset quality.

There are several areas within our portfolio that we can expect to benefit from higher interest rates driven by an improved economy. Those with exposure to economically sensitive businesses, such as residential housing and lodging – Newhall Land, Weyerhaeuser, Rayonier, Lowe’s, Hyatt and Hersha Hospitality – are good examples. Real estate companies that are active value creators through development and redevelopment-led business models in markets with high barriers to entry also have promising prospects as economic activity recovers. Companies fitting this description include Forest City Enterprises, City Developments, Songbird Estates, Brookfield Asset Management and Westfield Holdings. Also attractive are the M&A opportunities for companies that have important strategic value within their sectors, such as Hammerson, Tanger Outlet, Brookdale and First Industrial.

Q: Only 42% of the fund was invested in U.S. domiciled companies as of December 31, 2013, meaning there is significant international exposure. What makes international opportunities so appealing to the portfolio managers today?

A: As value investors, it is important to understand that our geographic distribution at any point in time is generally a byproduct of what we perceive as the most promising investment opportunities. We have investments in companies in the United Kingdom, continental Europe, Hong Kong, Singapore and Australia that are not widely held by most real estate-dedicated investors, and we are increasingly allocating capital into Europe and Asia. Brazil too may offer an interesting long-term opportunity now. These international holdings offer the same characteristics we find attractive in all of our U.S. holdings – excellent financial position, undervalued share price, and above-average net asset value growth over the long term.

Q: The fund currently has a relatively large cash position. How do you feel about cash holdings?

A: We view our cash position as a residual in our investment process. We are willing to hold cash while we identify suitable investment holdings. At our foundation, we are risk-averse investors using a conservative analytical approach to both equity and debt investing, which oftentimes will be viewed as contrarian. We see cash today as the ultimate contrarian investment, earning very little but with huge potential upside when it is needed most.

Please contact Brian Pollak at brian.pollak@evercore.com with any questions about this and other funds that are available through the Evercore Wealth Management Efficient Architecture investment platform.
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