fter years of fear and worry, investors are right to guard now against excessive optimism. The S&P 500 Index returned about 32% last year, and sentiment as measured by investment advisor surveys is close to the maximum bullish reading. There are nagging concerns that this could all end badly, now that the U.S. Federal Reserve is finally dimming the lights on the monetary party.

By most measures, however, the good times have some way to roll. All eyes will remain on the Fed over the coming weeks and months. Janet Yellen, the new Fed Chair, appears to be of the opinion that forward guidance is more effective than quantitative easing. Therefore, it seems likely that the market reaction will remained buoyed by firm language from the Fed addressing an extended time line for rising rates.

Looking further ahead, the U.S. economy looks set to continue strengthening, fueled by pent-up household formation, a long-awaited housing recovery, technological innovation and adaption, an enormously significant oil and gas production boom and, most amazing
It was the best of times; it was the worst of times. With apologies to Charles Dickens, this seems a fitting description of the first five years of Evercore Wealth Management. Colleagues who had worked together for years enthusiastically reunited to launch a firm that we knew could raise a new standard in wealth management. And we did it just as confidence in financial institutions reached a nadir, with private investors reeling from the collapse of Lehman Brothers and the treachery of Bernie Madoff.

It was the best of times because former clients were so unhappy with the large institutions that had acquired their business that they were ready to hear what we were saying; that they would be better served by an independent firm that valued integrity and delivered advice and management of assets accordingly. And it was, without a doubt, also the worst of times. Who would want to move their assets to an untested firm when the whole financial world seemed in danger of collapse?

I am delighted to say that the brave clients who joined us in those early days, as well as those who came on board later, have reason to be glad that they did. We’ve recorded solid results across our business, always mindful of each individual and family’s attitudes to risk and other constraints. Many of our clients are, or were, business owners or executives with concentrated holdings, and it has been our privilege to help them reconcile the associated risk and opportunities. On balance, I think we’ve done a very good job.

Our success has also been in no small part thanks to the continued support of our colleagues at Evercore. I will be forever grateful that Roger Altman, the Founder and Executive Chairman, saw the same opportunity that I did back in 2008 and has been a client and advocate of our firm ever since. Evercore CEO Ralph Schlosstein is also approaching his five-year anniversary at the firm and takes the time on page 4 to share his views on our collective culture and future, and on his own wealth planning challenges.

It has been a very exciting and satisfying five years. We met our targets and ran our business the way we knew it should be run, staying true to our principles of independent advice, direct relationships and partnership values. In short, we put our clients first, and it worked.

Of course, we can do better still, building on our strengths and expanding our capabilities and services. Top of my list is a new and vastly improved client site, which we preview here on page 8 in anticipation of a spring launch. We are expanding our wealth planning reach, focusing on our Wise Women events series and other educational programs. And our robust Efficient Architecture investment platform, which combines our proprietary capabilities with carefully selected external managers, continues to grow.

As we look back on our first five years and forward to the next, we remain extremely grateful to our clients and our colleagues for their faith in our firm. We’ve had a wonderful time, even in the worst of times, and are excited about our future.

I wish you and your families a very Happy New Year.

Jeff Maurer
Chief Executive Officer
of all, a domestic manufacturing revival. We anticipate growth of close to 3% this year.

The European Union continues to lag the United States in recovery but is preparing to resume real growth in 2014, while Japan is making a concerted effort to end two decades of deflation. As for China, while it is unclear how much the country’s economic growth will slow and how successful it will be at decreasing investment spending and increasing consumption, we remain reasonably confident that its officials will continue to carefully manage the economy. For now, we are assuming China will continue to grow at about 7% per year, keeping it a significant contributor to global growth.

On balance, we believe that these positive trends will continue through 2014 and that the stock market should generate a positive return, in line with our long-term expectations of about 8.5%. Long-term interest rates rose rapidly last spring after the first hint of tapering and then stabilized at the higher levels when the Fed backed off. While we expect long-term interest rates to trend higher, we do not believe they will rise as rapidly as most investors expect. The increase should be slow enough so that a bond portfolio with a duration of about four years should provide a positive return ahead of the close-to-zero return offered by cash equivalents.

Sidelined investors express an underlying fear that inflation could take off at any moment because of the unprecedented buildup of excess reserves resulting from quantitative easing. However, the deflationary forces unleashed by the contraction of private credit after the financial crises remain powerful. For excessive inflation to take hold, wages would have to rise. There seems to us very little chance of that happening over the intermediate term.

Credit market strategies continue to be an effective part of a balanced portfolio, generating 5%-6% returns with very little interest rate risk. While credit spreads have narrowed, we believe these strategies continue to play an important role in a well-balanced portfolio.

Diversified market strategies were disappointing in 2013 due to the significant drop in the price of gold, which reflected the flat-to-down trend in inflation. We continue to believe it makes sense to have a gold position in a balanced portfolio as a hedge against a sudden increase in inflation expectations, which could still happen, given the tremendous buildup of excess reserves in the banking system. It will be difficult for the Fed to soak up the excess liquidity if animal spirits infect the banking community, which invariably happens toward the later part of an expansion.

Our balanced portfolios are designed to benefit from a continuation of the economic expansion, while limiting the various risks as much as possible. After four years of guarding against excessive pessimism following the trauma of 2008, it is now becoming important to guard against excessive optimism. However, it’s important to note that bullish sentiment is not as accurate a signal of a market top as bearish sentiment is a signal of a market bottom. Optimism and the underlying growth forces that accompany it have a tendency to last far longer than fear and contraction.

John Apruzzese is the Chief Investment Officer at Evercore Wealth Management. He can be contacted at apruzzese@evercore.com.

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When I joined Evercore, we had the hypothesis that the firm could emerge from a “boutique” and grow to become a leading global advisory firm, while staying true to the fundamental principles of excellence and integrity that Evercore was founded on 18 years ago. But it was just a hypothesis at that time. Fortunately, we are making some progress in turning that hypothesis into reality.

Our approach – the lack of conflicts, the independence of advice, the level of attention that we provide to our clients in which very senior people not only pitch the business but also do the business – has been embraced, by corporate leaders, boards of directors, and high net worth individuals. We have an unstinting commitment to excellence, in everything we do and in every interaction we have with our clients.

At the same time, integrity is fundamental. In the case of wealth management, we are a fiduciary for our clients; that’s a responsibility we take very seriously. In our investment banking business, our clients rely on us to give them the very best unconflicted advice, both on the merits of transactions and how to execute them.

The way in which we operate our businesses is also important. Somehow, in some firms, particularly in financial services, it seems that people can treat others in a way that they themselves would not want to be treated. I feel very strongly that there is no role for that at Evercore. To me, respect is a central value. We have respect for the people with whom we work, respect for our clients, and respect for the businesses and people providing services to our firm. Culture is incredibly important to businesses that compete solely on the basis of their intellectual capital, their relationships and the quality of their people.

My hope for the wealth management business is that it will continue to grow and thrive, expanding its role within Evercore as it does so. Certainly, there is great opportunity for Evercore Wealth Management. There are more people now than ever before at every stage of the net worth continuum, with significant investable resources. And the outlook for the U.S. economy is generally bright, with strong tailwinds from the housing recovery, technological innovation, and a surge in both domestic energy production and manufacturing. These investors are seeking very high quality, independent and conflict-free advice and, of course, the good returns that they would expect to accompany this advice.

A Wealth Planning Challenge

One very personal observation, about which I think a lot, is that my children are growing up in a much more financially well-off environment than my wife and I did. We work as hard as we do in part to provide a better life for them. But we don’t want what we have been able to achieve to destroy or weaken their sense of motivation or accomplishment.

Everyone who comes from a lower-income background and has achieved some financial success struggles with balancing what they provide their kids and how hard
they want them to struggle. At the end of the day, it is a very personal decision, and one that should be tailored to the needs of the children in each family. But I do think we can learn from the thought processes of other people – and from working with advisors who really listen. One of the things we do especially well as a firm in both our advisory and wealth management businesses is to listen to our clients.

**Looking Forward**

It turns out that our hypothesis has been correct; that we can grow while staying true to our culture. We are becoming the place that the most talented advisory professionals want to work and the place that the most talented wealth management professionals want to work. What has surprised me has been the pace at which our approach has been embraced, by corporations, boards of directors, and private clients.

On the advisory side, our market share in 2008 among the 13 advisory firms that are public and report their advisory fees separately was 1.3% of the total fees paid to those firms. Now it’s about 5.6%. That’s a large and rapid change in a business that is highly competitive and mature.

Similarly, for Evercore Wealth Management to have gone from a standing start in 2008 with zero assets under management to close to $5 billion today reflects a rapid embrace of both the business and its approach to client service.

As I approach my five-year anniversary at Evercore, I feel very fortunate to be in a firm with such talented professionals who are so deeply committed to our values of excellence and integrity.
After the tax dramas of last winter culminating in a substantial rise in marginal income tax rates and the new Medicare surtax on investment income, investors can look forward to a more stable tax and planning environment in 2014.

It is important to note, however, that the gift, estate and generation-skipping transfer tax exclusion amounts will be adjusted for inflation this year, increasing to $5.34 million from $5.25 million in 2013. For individuals who had reached their previous exclusion limits, this may present an additional opportunity for further wealth transfer.

Chris Zander is the Chief Wealth Advisory Officer at Evercore Wealth Management. He can be contacted at zander@evercore.com.

### Federal Estate, Gift, Generation-Skipping Tax Landscape

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<thead>
<tr>
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<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td><strong>Annual Exclusion</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single Person</td>
<td>$14,000</td>
<td>$14,000</td>
</tr>
<tr>
<td>Married Couple/Gift Splitting</td>
<td>$28,000</td>
<td>$28,000</td>
</tr>
<tr>
<td>Gifts to Non-U.S. Citizen Spouse</td>
<td>$143,000</td>
<td>$145,000</td>
</tr>
<tr>
<td><strong>Lifetime Gift Tax Exemption</strong></td>
<td>$5,250,000 (indexed)</td>
<td>$5,340,000 (indexed)</td>
</tr>
<tr>
<td><strong>Maximum Gift Tax Rate</strong></td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Estate Tax Exemption</strong></td>
<td>$5,250,000 (indexed with portability)</td>
<td>$5,340,000 (indexed with portability)</td>
</tr>
<tr>
<td><strong>Maximum Estate Tax Rate</strong></td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Generation-Skipping Tax (GST) Exemption</strong></td>
<td>$5,250,000 (indexed)</td>
<td>$5,340,000 (indexed)</td>
</tr>
<tr>
<td><strong>Maximum GST Tax Rate</strong></td>
<td>40%</td>
<td>40%</td>
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This chart does not include any possible state estate tax rates, rules, or exemptions.

### Federal Income Tax Landscape

<table>
<thead>
<tr>
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<th>2013</th>
<th>2014</th>
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</thead>
<tbody>
<tr>
<td><strong>Top Federal Marginal Tax Rate for Ordinary Income</strong></td>
<td>39.60%</td>
<td>39.60%</td>
</tr>
<tr>
<td><strong>Long-Term Capital Gains</strong> (assets held &gt;1 year) – Top Bracket</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Long-Term Gain from Collectibles</strong> (art, precious metals, etc.)</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td><strong>Short-Term Capital Gains</strong> (assets held &lt;1 year) – Top Bracket</td>
<td>39.60%</td>
<td>39.60%</td>
</tr>
<tr>
<td><strong>Qualified Dividend Income Tax Rate – Top Bracket</strong></td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Medicare Surtax</strong>*</td>
<td>3.80%</td>
<td>3.80%</td>
</tr>
</tbody>
</table>

* The Medicare Tax is part of the Health Care Reform Act passed in 2010. As it applies to individuals, a tax equal to 3.8% will apply to the lesser of:
  A. Your net investment income for the year, which includes interest, dividends, and net capital gains (including gain on sale of investment property as will be discussed further) or,
  B. The excess (if any) of your modified adjusted gross income in that taxable year over the threshold amount of $250,000 for married couples filing jointly and $200,000 for single filers.
Wealth Planning
Tech Savvy and Forever Young

by Jeff Maurer

Last weekend I attended class at the University of Pennsylvania to learn about the Affordable Care Act and attended a National Geographic lecture on Borneo titled Paradise Under Siege; I reviewed my Evercore Wealth Management accounts; and I enjoyed a video conference with my grandchildren – and I did it all without leaving my study. Our digital world fascinates me more each and every day.

My contemporaries, the vanguard of the Baby Boom, have by and large embraced technology. Over half of Americans over 65 years old are now online, according to the latest Pew Research, up from just over one-third five years earlier, a trend that appears to have been driven by our generation. Many of us have witnessed older relatives, friends and colleagues become Luddites – turn their backs on personal computers, email and social media – and unintentionally isolate themselves as a consequence. (Only 34% of Americans age 75 and older use the Internet, according to that same study.)

It’s not always easy to keep up, especially as the pace of change continues to accelerate and devices seemingly get more sophisticated, but it seems to me essential to do so.

Of course, I have always had good business reasons to keep on top of technology, even since I first started keeping financial records online in the early 1990s. The scheduled launch this coming spring of the new, state-of-the-art Evercore Wealth Management client website, which I address on page 2, is a case in point. I am old enough to remember hefty paper files and banking transactions that took days – and I can say without reservation that clients are better served now, as long as their advisors understand the importance of the timeless human touch and realize that technology is only a tool.

Technology can also be a great source of pleasure. Although online college courses have been available on the Internet for years, they have proliferated and are readily available from elite schools all over the world. I can access an astonishing range of courses on my iPad from the iTunes U application or from Coursera or Kahn Academy. I also utilize the applications to access courses on photography – digital, of course.

My iPad and Kindle, which are always synchronized, allow me to travel with a full library and the latest editions – including Golf and National Geographic, as well The Wall Street Journal, Barron’s, The New York Times and The Economist, which has a nifty audio option. They even help me keep fit: The time on the elliptical machine goes a lot faster with a good read or show.

Technology and music are now synchronous, as I travel with satellite radio, Pandora and iTunes listening to Dylan’s wonderful lyrics and trying to remain Forever Young.

May your hands always be busy,
May your feet always be swift,
May you have a strong foundation
When the winds of changes shift.
May your heart always be joyful,
May your song always be sung,
And may you stay forever young.

Technology, while not yet able to deliver on the song’s promise, can help us stay sharp, fit and fully engaged with work, friends and, in my case, four generations of family. I can’t wait to see what comes next.

Jeff Maurer is the CEO of Evercore Wealth Management. He can be contacted at maurer@evercore.com.

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A NEW CLIENT WEBSITE IN 2014

by Jason Anderson

At Evercore Wealth Management, we have always believed that technology is a tool that enhances, rather than replaces, the direct relationships between our clients and their wealth advisors and portfolio managers. That’s why our tools need to be of the highest standard, enabling our clients to access their information at any time, to discuss with their advisors as and when they wish.

Recent advances at the firm run the gamut from trading to reporting solutions. Here we focus on our new client website, scheduled for release this spring. Initial features include:

- Support for a wider range of Web browsers and platforms, including mobile devices such as tablets and smart phones
- A dedicated mobile app that provides the same functionality as the browser-based access
- A summary of our proprietary view of assets and portfolio construction
- Live views of data that can be individually customized
- Dynamic charts and data that can reveal the underlying data
- Report views that support summary and detailed information at the portfolio and portfolio group levels
- Performance overview reporting
- Integration with market data
- A document vault for storing and sharing documents
- The ability to export data to local spreadsheets
- A secure, industry-standard technology platform
- An internal and client-centric support service

We are excited about the new website, which will be accessed through the public site, www.evercorewealthmanagement.com. There’s more to come, but please feel free to contact me in the interim with any questions you might have.

Jason Anderson is a Partner and the Chief Technology Officer at Evercore Wealth Management. He can be contacted at jason.anderson@evercore.com.
Defensive Assets
A Safe Harbor In Any Scenario

by Jim Holihan

Aft er Hurricane Sandy blasted the northeast last year, many residents took precautions by purchasing home power generators in record numbers, only to witness one of the quietest hurricane seasons in decades. In the same vein, bond investors who suffered widespread losses during the summer sell-off are braced for more of the same, despite yields that are over 100 basis points higher than those available in early May. Indeed, roughly $171 billion has been pulled from bond mutual funds since last spring, according to Investment Company Institute, despite continued reports of subpar growth, benign inflation and stubbornly high unemployment.

So are we heading toward another calamity in the bond market or is human nature such that we look to overprotect against that which has already taken place?

Human nature aside, there are legitimate reasons for bond investors to be concerned about higher rates. First and foremost is the extraordinary range of low levels that we have experienced over the past few years. Second is the inevitable end of the Federal Reserve’s balance sheet expansion, as discussed by John Apruzzese on the cover of this issue, specifically the $85 billion per month bond purchases. Third is the growing evidence of strength building in some sectors of the U.S. economy.

Housing prices have stabilized and are now improving while manufacturing has, for the first time since the 1940s, strung together three consecutive years of positive growth. Increased production of relatively cheap domestic energy is a large contributing factor toward this ramp-up in production and could remain a catalyst for U.S. manufacturing growth for many years to come. In addition, domestic auto sales have experienced nothing short of a renaissance and continue to gain market share.

As the S&P 500 index hovers around all-time highs and most conservative bond portfolios end the year flat to slightly negative, investors should be reminded that their allocation to fixed income is there for a reason.

While it is true that most economists agree that the Fed will continue to taper in 2014, tapering may already be priced into the bond market after this summer’s sell-off. In addition, it seems likely that the Fed will provide forward guidance toward extending its zero interest rate policy perhaps well into 2016. With no inflation, the yield curve already historically steep and short-term interest rates seemingly fixed at zero percent for the next two years, interest rates may not move higher. Keep in mind too that the last two times the Fed ended a quantitative easing program, interest rates actually fell.

The only certainty in the markets now is that federal income taxes are higher this year than 2012 (as discussed in previous issues of Independent Thinking). In addition to higher income tax rates for those in the top bracket, investors with income levels above $200,000 for single filers and $250,000 for joint filers will be subjected to a Medicare surtax of 3.8% this year on every extra dollar of investment income – be it dividends, capital gains or investment income – with the exception of municipal income, which remains tax-exempt.

For investors in the highest tax brackets who seek income, yield, diversification and safety of principal, tax-free
Taxable equivalent muni yields for a 10-year maturity

Source: Bloomberg, 39.6% calculation includes 3.8% Medicare surtax

Municipal bonds with maturities of between two and 12 years seem to us the most attractive defensive investment now. An actively managed diversified portfolio of high-quality municipal securities should provide investors with a hedge against an increase in risk in the equity markets and, as illustrated in the chart above, the best relative after-tax returns compared with other fixed income sectors.

The old adage, “It’s not what you make, but what you keep,” will become even more apparent in April when the reality of the new surtax kicks in.

Jim Holihan is a Partner & Portfolio Manager at Evercore Wealth Management. He can be contacted at holihan@evercore.com.

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Defensive Assets
Affording Affordable Care

by Howard Cure

As the federal government scrambles to cure the ills of the Affordable Care Act, or ACA, states, cities and local hospitals remain under considerable financial pressure. States are still responsible for running their versions of Medicaid; cities are still caring for their indigent populations; and hospitals are operating under new and constantly changing circumstances.

For investors in municipal debt, the troubled launch of the ACA serves as a reminder that it is important to distinguish the issuers that are able to absorb inevitable bumps along the road from those that are ill-prepared as the United States reinvents healthcare. While it is still early, some entities – including the states of New York and California – will fare better than most.

Health Exchanges and State Finances

Following the Supreme Court’s decision in 2012, state officials are now deciding whether to expand their Medicaid programs under the ACA. As anticipated in our paper, “Unwelcome Side Effects: The Financial Implications to the States of the Affordable Care Act,” published on August 15, 2012, hundreds of thousands of people in the states that have opted to expand their Medicaid program were prequalified because they were already enrolled in various low-income state programs. Another reason for the big numbers is aggressive outreach in many states. While this rush to enroll in Medicaid indicates a strong demand for healthcare coverage among these Americans, it is more a function of states’ proven ability to find, educate and enroll low-income residents than an indication of a structural imbalance between the needy and healthier people who can afford insurance.

Nearly every state that created its own exchange is also expanding Medicaid to childless adults earning up to 138% of the federal poverty level (the new Medicaid limit under the ACA). Even states that aren’t expanding expect a bump in enrollment from the so-called woodwork effect, driven by people who discover that they are eligible under existing requirements when they visit the federal exchange. Since these eligible people are already entitled to existing Medicaid coverage, the federal government will only provide a portion of the costs, ranging from 50%-80% of the total, depending on a state’s average income. This compares with 100% funding for expansion costs for states complying with the Medicaid expansion under the ACA for the first two years, tapering to 90% by 2020 and beyond.

The most pressing and politically charged issue of the rollout is the cancellation of an estimated 10-15 million existing individual health insurance policies. Allowing non-ACA compliant plans to be renewed could increase adverse selection risk on the public health insurance exchanges. In this circumstance, adverse selection is based on the idea that buying health insurance is more attractive financially for those who are ill. Those previously insured on the individual market, particularly the young and healthy, could have less incentive to purchase a replacement policy on the exchanges in 2014. This could further slow the ramp-up of health plan enrollments, which have already fallen short of expectations, thanks to the botched rollout of the ACA. Weak enrollment and a risk pool composition that skews significantly toward older and sicker patients would negatively affect the business plans of insurers.

The financial burden on a state of increasing the Medicaid enrollment without expanding the program could be costly. The health of people going to Medicaid offices through the woodwork effect matters a lot more than their overall numbers. With a program like Medicaid, which is prone to unpredictability and cost overruns, many state officials have had to budget carefully. Some, including New York and California, have been more successful than others.

Even before the implementation of the ACA, New York had begun to redesign its Medicaid system to simplify the program, improve quality of care and reduce costs. This was done primarily by expanding enrollment in the Medicaid managed care program and is intended to provide an organized system.
of care, an accountable entity, and the ability to coordinate and manage care.

In California, the state had to grapple with a decade of budget deficits that resulted in significant cuts to healthcare. The counties have traditionally had broad authority over the provision of health-related services with programs funded by a complicated mix of local, state and federal funds. California’s Medicaid program, known as Medi-Cal, is large, with spending per enrollee set at the lowest in the nation following recent Medi-Cal provider rate cuts to help balance the state budget. California, like New York, plans to move seniors and persons with disabilities into managed care arrangements.

**Implications for Local Governments**

States are seeking to harness the new Affordable Care Act healthcare benefit exchange to reduce local governments’ employee and retiree healthcare costs. This effort is one of several strategies that local governments have been pursuing to control healthcare expenditures. Others include shifting retirees to ACA Healthcare Exchanges (retirees under the age of 65 meeting certain income thresholds are eligible to transition their healthcare from the municipality to the federal government’s budget), reducing benefits and raising employee co-pays, and transferring retirees to Medicare as soon as they are eligible.

For example, officials in financially destitute Detroit hope to point some of the city’s older employees (those who are still too young to qualify for Medicare) to the ACA’s insurance marketplace. This would shift a portion of the city’s healthcare costs to the Federal Government through the ACA and the program to subsidize a portion of these insurance policies based on income.

**Impact on Hospitals from Health Insurance Exchanges**

In the short term, hospitals would be relatively unaffected by the policy renewal proposal, as long as consumers are insured under their existing plan or are newly insured under an exchange plan or Medicaid. However, over the long term, dysfunctional exchanges would be detrimental to hospitals if the level of uninsured or underinsured individuals remains high. Hospitals in markets afflicted by adverse selection would likely struggle to maintain profitability, as they would still be exposed to significant bad debt and charity care expenses, while scheduled federal Medicare and Medicaid reimbursement cuts under the ACA would still be implemented.

Disproportionate Share Hospital, or DSH program, is a federal subsidy given to hospitals that treat low-income populations. The ACA cuts $500 million, or 4% of current spending, on $12.5 billion from the program in this fiscal year and $18.1 billion cumulatively over the next six years. While that was supposed to be offset by the millions signing up for the expanded Medicaid program, those numbers have not yet materialized. To the extent that fewer individuals purchase insurance on the exchanges, hospitals will be forced to absorb these rate reductions in uncompensated care.

Recent decisions by many large companies to discontinue employee-sponsored coverage and move active enrollees into private exchanges will also have an impact on hospital revenues. It seems likely that employees will be more judicious with their healthcare choices and become price-sensitive consumers. The not-for-profit healthcare sector as a whole could very well face weakening financial conditions as hospitals adjust to changing dynamics brought on by the ACA. As a result, we continue to be very cautious in our healthcare bond purchases, looking primarily at multi-state hospital systems or ones that dominate their local market with large balance sheet resources and/or are affiliated with major universities.

In short, hospitals need the ACA to work – as do, ultimately, the states and local municipalities. In the interim, the ACA is being used as a political cudgel to discredit the President and those that supported it. In this environment, it is difficult to implement repairs and improvements to the program. We will continue to update investors as these issues are resolved.

Howard Cure is the Director of Municipal Bond Research at Evercore Wealth Management. He can be contacted at cure@evercore.com.
Growth

Fair Winds in the Equity Markets

by Tim Evnin

U.S. equities have had a great run. The S&P 500 Index rose about 32% in 2013 and about 150% since the depths of the downturn in 2009. This performance has sparked a heated debate as to whether there is anything left for investors and even some talk about a new equity bubble.

Our sense is that over the short term the easy money has been made, but there are still good returns to be had by owning and buying equities, both in the United States and in other markets.

The S&P 500 dropped over 50% from peak to trough in the 2007-2009 period. While a bit difficult to measure a body in motion, especially in violent motion, the market probably troughed at about nine to ten times forward earnings. Since then, both earnings and the multiple paid for those earnings, or the price-to-earnings ratio, have grown. In rough terms, earnings are up about 60%-65% and the multiple has gone from 10x to 15x. This combination drove the 150% return.

At 15x 2014 earnings, we would view the market as generally fairly valued. By this, we mean that a long-term investor – one who plans on owning equities for ten-plus years – should neither be helped nor harmed by a change in price-to-earnings multiples. Empirical studies show that an investor’s long-term returns can be heavily influenced by the market valuation upon entry. And, at 15x earnings, the prevailing wind seems fair.

Why is 15x reasonable? Well, for historical purposes, the multiple is within a long-term average range. From a valuation perspective, it also seems palatable. By taking the inverse of the price-to-earnings ratio – the earnings-to-price ratio – investors in the S&P 500 would theoretically be earning a 6.7% yield on their investment; not spectacular, but a lot better than the returns generated by many other investment options.

So why the bubble talk? We would posit a couple of reasons, and we are sure that there are others. The first is simple: Bubbles get press. Second, investors as a group, having survived a traumatic experience in 2007-2009, are constantly looking over their shoulders for the next destroyer of wealth. With so many having misjudged the last real bubble – which was mostly in financial securities, financial industry companies and anything housing-related – many now see danger lurking in any shadow. And last, a classic behavioral reflex is to think of the current market level from the perspective of the depths it plumbed just a few years ago, rather than over a much longer continuum.

While it is nice to have the wind at your back, it is not essential. With the market fairly valued, the focus must now be on the specific companies owned and their return characteristics and growth prospects. At Evercore Wealth Management, we continue to own a diversified but concentrated group of about 35 companies in our core equity portfolios. While it is admittedly harder to find good values now, we have been finding some, including our most recent purchase: CBRE Group, the leading commercial real estate services company. CBRE has changed its business mix dramatically over the past several years, making it more stable and generating great opportunities here and abroad.

At our purchase, it was a bit under 15x forward earnings.

It’s been a great run, but we believe that there is a lot of latent potential in our existing holdings and also believe that these new additions are very attractive. We look forward to a rewarding 2014.

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Editor’s Note:

Evercore Wealth Management enhances its core investment capabilities with a range of carefully selected and managed external funds, including credit strategies. Here we interview Jeff Gary, the senior portfolio manager of the Avenue Credit Strategies Fund at Avenue Capital Group.

Q: How is Avenue Credit Strategies (ASCBX) different from a typical high-yield mutual fund? What is the goal of the fund?

A: Avenue Credit Strategies Fund is an opportunistic fixed income strategy that currently invests in high-yield bonds, bank loans and stressed, distressed and convertible securities. About 20% of the portfolio is international. We have a concentrated portfolio with approximately 50-80 names and are able to use hedging strategies. The objective of the fund is to seek total return, primarily from capital appreciation, fees and interest income. We seek to achieve attractive, risk-adjusted returns to our investors while also focusing on managing the downside.

Q: Tell us a little about the resources of Avenue Capital Group and how the fund interacts with the broader firm.

A: Founded in 1995, Avenue Capital Group has approximately $13 billion in assets under management, as of November 30, 2013, and 206 employees in eight offices around the globe. The fund has the ability to invest in up to 20% of the same investments as Avenue’s private funds and to leverage the resources of 50 investment professionals.

Q: Explain the differences between distressed, stressed and performing bonds? What is the difference between senior secured loans and unsecured bonds?

A: Performing bonds are typically priced at, above, or close to par, and are currently paying their coupons. Stressed and distressed securities are typically trading below par (sometimes substantially), and in some cases, are not paying a coupon at all. Senior secured loans are typically first in line in security order. Unsecured bonds are liabilities not necessarily covered by corporate assets.

Q: You note that the fund is able to hedge. What is the focus of the fund’s hedging program? Does it hedge interest rates, credit, or both? As a percentage of the portfolio, how large is the hedging book typically expected to be?

A: Our focus has predominantly been on macro-hedging to dampen the volatility of the portfolio. Historically we have been, and anticipate to be, focused on both credit and interest rate risks in our hedging program. We expect to hedge a portion of the fund’s NAV, depending on the market environment, with our defensive strategies utilizing shorts and cash on hand.
Q: Credit spreads have compressed, and high-yield and distressed bonds and loans have had a historically great five-year run. What is your outlook on the credit markets going forward? Where do you expect default rates to be over the next year? How do you expect credit broadly, and specifically the fund, to perform if interest rates continue to go higher?

A: Spreads in the high-yield and bank loan markets remain attractive, near 500 basis points in relation to low short-term interest rates and continued low inflation and default rates. This may lead to spread tightening over the next one to four quarters.

Default rates in the United States, excluding any large company filing, are expected to remain below 2% in 2014 but should continue to provide ample distressed investment opportunities. Defaults and distressed loan sales from commercial banks in Europe may remain elevated and, we believe, have potential to increase in 2014.

Despite the Federal Reserve’s plans to eventually taper its bond purchases, officials have committed to maintaining short-term rates near zero for an extended period of time. This should continue to drive demand for higher yielding asset classes, including credit, that have traditionally experienced less interest rate sensitivity. We believe that potential volatility from the Fed’s actions and higher interest rates could result in attractive sell-offs in specific stressed and distressed securities. These would represent attractive opportunities for the fund.

Q: In what environments would you expect this strategy to perform poorly?

A: In general, macro-events that cause a so-called “risk-off” environment (in which risky securities are likely to decline in price) would most likely cause the fund’s net asset value to decline. But we believe that the fund’s cash position and hedges should offset some of this decline. In addition, the fund is well-positioned with its large, experienced investment team to opportunistically add to existing positions and try to capture better-priced investment opportunities that we have researched.

Q: How correlated do you expect this type of strategy to be to the broad equity market?

A: The JP Morgan High Yield and Leveraged Loan Indices have historically had a 0.62 and 0.48 correlation, respectively, with the S&P 500. The fund invests in high-yield bonds and leveraged loans, as well as convertible bonds across the performing, stressed and distressed universe. Further, the fund utilizes an event-driven strategy. As a result, we would anticipate that the fund would have correlation to the broad equity market but that the magnitude of the correlation could fluctuate based on the timing of the event-driven investments.

Q: What type of total return would you expect the fund to generate over the course of a typical economic cycle?

A: The fund’s objective is total return and not absolute return.
The Evercore Wealth Management standard is rooted in client relationships, shaped by our investment expertise and secured by the backing of a powerful, like-minded institution.

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