Investment Outlook: Staying on Course in Volatile Markets

Planning Strategies for Now and the Long Term

Baby Boomers: Perspective on the Markets

Illiquid Alternatives: A Primer

Financial Education for the Next Generation

California Bonds: Preparing for a Rainy Day
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We’ve stayed close to our clients through it all, aiming to help them achieve their financial objectives while always mindful of individual and family goals and attitudes to risk. It seems that our approach – so different from that of the big banks andbrokerages – has paid off, in performance, in client and employee retention, and in the continued growth of our firm.

What comes next? The future looks both challenging and exciting. The stock market gains of the past seven years – with the S&P 500 index up 15.69% since February 3, 2009 on an annualized basis, and our core equity portfolio up 16.47% over the same period – are unlikely to be repeated in future years. And, as John Apruzzese, our Chief Investment Officer, writes in this issue of Independent Thinking, there are other risks on the horizon, notably the continued reluctance of the Federal Reserve to raise interest rates, as well as the slowdown in China and the prospect of a messy run-up to the U.S. Presidential election.

At the same time, we are confident in our investment and planning approach. As readers of this publication know, we reduced our capital market assumptions some time ago and, to the extent that they were overweight in equities, rebalanced client portfolios well ahead of the recent market downturn. We invested the proceeds in noncorrelated and illiquid assets; Portfolio Manager Stephanie Hackett provides a primer on illiquid assets here on page 17. We will continue to expand and refine our investment asset classes, combining our proprietary expertise in core equity and fixed income with carefully selected external investments to strive to produce the best possible after-tax, after-fee, risk-adjusted returns.

We are also investing in our fiduciary capabilities. Our size, our approach, and the global resources and strength of Evercore makes us an appealing alternative to the bigger trust companies and banks. Many of our clients already rely on our affiliate, Evercore Trust Company N.A., to act as their corporate fiduciary and as their trustee or executor. They know that we are unusually responsive and flexible, and that we excel in the areas that are critically important to clients and in balancing the intent of the benefactor with the continued well-being of the beneficiaries.

Volatile markets are uncomfortable, particularly for those of us who are longer in the tooth and have less time to recover losses (which I address in my regular Baby Boomer column on page 14). However, volatility can also spark opportunity.

Chris Zander, our Chief Wealth Advisory Officer, reviews some very topical wealth planning strategies on page 8. We also highlight some end-of-year wealth planning considerations on page 10, which we are using in our ongoing discussions with our clients.

I hope you enjoy this issue of Independent Thinking. As always, please don’t hesitate to contact any one of us at Evercore Wealth Management to discuss these topics or anything else on your mind. We knew back in 2009 that individuals and families are best served by a direct relationship with the investment and planning professionals who manage their wealth – and these wonderful seven years have only reinforced that view. We welcome your engagement as we look forward to the future.

Jeff Maurer
Chief Executive Officer
Staying on Course in Volatile Markets

By John Apruzzese

Now is always the hardest time to invest. It’s hard in bull markets, when investors fear that they are buying at the top, and in bear markets, which may have further to fall. It’s hard too in volatile markets like the one we are experiencing now, when competing forces obscure the investment outlook. There is nevertheless much we can do to manage risk and to seek to preserve and grow portfolios, even in turbulent times.

The risks troubling investors are mostly known. The Chinese economy has slowed, bringing expectations for global growth down to just 3%, according to the latest World Bank figures, the lowest level in decades apart from a brief period at the nadir of the Great Recession. Europe is careening from a Greek debt crisis to an immigration crisis. And the U.S. Presidential election is looking very much up in the air, with the distinct possibility of a nominee with no previous political office experience.

What is not known – and is driving much of the current market volatility – is when the Federal Reserve will finally increase rates. As the chart on page 4 illustrates, market expectations for the path of interest rate hikes do not agree with the Fed’s own expectations – and it’s worth noting that, so far, the market has been more accurate than the Fed. We’ve had three rounds of unprecedented quantitative easing and seven years of near rock-bottom interest rates. Proponents of continuing this policy, including the International Monetary Fund, have been very vocal about the risks of raising rates in this low-growth environment. Less discussed are the
consequences of failing to do so. The markets have become addicted to artificially low rates, in a way that is neither healthy for the economy nor sustainable. Tough love from the Fed may cause some short-term pain, but it is time to start back on the path to a normal monetary policy.

Against this backdrop, the domestic picture remains relatively bright. Auto sales and housing starts are rising, unemployment at 5.1% is low, and the country continues to lead the world – by a long shot – in innovation. The U.S. stock market has corrected and is now selling for around the average historic valuation, which seems to us close to fair value in the current economic environment.

So, what can investors do, while waiting for the outlook to clear? Periods of volatility present opportunities in wealth planning (reviewed by Chris Zander on page 8), and in investing.

As discussed in the previous issue of Independent Thinking (and well before the 12% stock market correction in September and the market’s current volatility), we reduced our long-term return expectations for both stocks and bonds, and increased our exposure to uncorrelated and illiquid assets. To the extent that equities in client portfolios had increased faster than the rest of the portfolio, we rebalanced back to the target allocation.

The proceeds are invested in our Diversified Market Strategies and Illiquid Alternatives asset classes, both of which are anticipated to boost portfolio returns in volatile conditions.

3%
global growth expectations:
The World Bank
Our Diversified Market Strategies asset class is expected to boost portfolio returns in these conditions because it is exposed to risks and returns that are largely unrelated to the direction of the major markets. The allocation currently includes investments in Gotham Neutral Fund, the AQR Multi-Strategy Alternative Fund, and Stone Ridge All Asset Variance Risk Premium Fund.

In a similar vein, the case now for illiquid alternatives seems appealing. Investments in inherently inefficient markets, such as private equity and private real estate, allow for the possibility of returns significantly higher than average returns. Stephanie Hackett discusses our approach to this asset class on page 17.

We remain positive on equities over the long term. Now that valuations have returned to more normal levels, following waves of indiscriminate selling, we are actively investing in companies with superior fundamentals, such as Blackstone, CBRE Group, and AutoNation.

It may take some time until the full impact of the Chinese slowdown is played out, in both the emerging and developed markets, but we are confident that the United States will remain on solid footing. The Federal Reserve will eventually raise rates and the concerns around the U.S. election will abate, hopefully by the primaries and certainly by the general election (although that may feel more like a lifetime than a year to those of us in heavily contested states).

In the interim, we remain focused on our clients’ long-term goals. Now may be a hard time to invest, but we are confident that we are building and managing well-balanced portfolios with the aim to withstand periods of volatility and benefit from opportunities in a changing economy.

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Federal Funds Rate Expectations

At some point, the Federal Reserve will begin to raise rates, but its stated intention is to raise slowly. The market currently discounts an even shallower path than the Fed’s projection.
Investing in Interesting Times: Evercore ISI’s Donald Straszheim on China

ON ECONOMIC GROWTH

The Chinese government’s 2015 growth target is 7%. Official third-quarter growth was reported at 6.9%, and first- and second-quarter growth were both at 7.0%. We don’t believe these values are plausible; the real rate is probably between 3% and 5%.

Many investors are worried about how this slowdown will play out, but we are not as concerned as some. There are green shoots in China that don’t get much press. Passenger and commercial vehicle sales are up, as are a number of other important data, including housing, lending and electricity – so, it’s not all bad. Moving forward, we expect China’s macro indicators to be generally better over the coming months.

The country faces some of its toughest policy choices since 1978, maybe even since 1949. The government now seems to be putting reform on the back burner, as it refocuses on growth. Interest rates have already been cut six times and the currency has been devalued. The current policy clearly is to lift growth, and lift it fast.

ON THE CHINESE CURRENCY

On August 10, 2015, China abandoned 10 years of currency policy to devalue the yuan 3% over three days. That was a big deal. China’s Forex reserves are still enormous: $3.5 trillion down from $4 trillion a year ago, but still up from $1.5 trillion in 2007. We see this issue as manageable. We believe that the Chinese government will now manage the yuan against a basket of currencies, rather than just against the U.S. dollar.

ON CHINESE EQUITIES

Investors should stay away from Chinese A-shares. There is no obvious end game here, now that the assets of most insiders are frozen, and it is not clear to us that the government feels like there even needs to be an end game. The prospect of equity financing in China has been massively damaged, and small, innovative companies have been badly hurt.

As long as the equity market is a government operation, instead of a real market, we are not interested.

ON THE LONG-TERM OUTLOOK

The markets have overreacted to the slowdown in China. While there are serious problems in the country, the end is not nigh. Yes, economic growth has been slowing since 2010, but that’s to be expected, given how large the economy has become. While the era of 10% plus growth is over, China’s economic rise will continue.

Editor’s note: Evercore ISI is a leading provider of sell-side research in the United States and one of the providers of research to Evercore Wealth Management. Here is an extract of a recent conference hosted by Donald Straszheim, Head of China Research at Evercore ISI, for the firm’s clients.
Fiscal Tremors in California

By Howard Cure

While California has shown strong improvement in its fiscal affairs in three years, the state’s revenue base remains unstable. A highly progressive income tax structure, which makes California vulnerable to financial market performance, exposes the state to wide budget fluctuations and the prospect of a structurally unbalanced budget, which could be further exacerbated if another economic recession were to occur.

Among the few certainties in California is that voters will have ample opportunity next November to express their views. There is potentially an opportunity for voters to help create funding sources or solutions to such varied needs as state budget stability, education and medical funding, transportation infrastructure improvements, sales tax code overhaul, and pension reforms.

Of these, the most pressing is deciding whether to extend or let expire the additional income and sales tax revenues of Proposition 30. The narrowing of spreads compared to the AAA Municipal Market Data (MMD) scale since the proposition was passed in 2012 suggests that the bond market has recognized the advances that California has made in structurally balancing its budget. While we expect that the state will continue to exhibit fiscal discipline by implementing tax and policy reforms, and not financially overburden the underlying entities, we are mindful that failure to do so will cause spreads to widen and the pressures on local entities to increase. Rating downgrades would most likely follow.

It is also worth noting that any move to stabilize state revenues by de-emphasizing income taxes would appear to shift the burden from the wealthy to the broader population in a state that is already sensitive to income inequality. Proposition 30 raised income taxes on the wealthiest 4% of Californians (individuals earning more than $250,000 a year) for seven years. In the year prior to the passage of Proposition 30, the wealthiest 4% paid 60% of state income tax. In the first year of Proposition 30, their contribution jumped to 60%. The proposition also raised the sales tax by 0.25% for four years. The measure is now responsible for $8 billion in annual revenues, nearly $7 billion of it from income taxes. The sales tax provisions will phase out in 2016, and the measure will fully expire in 2018. The 2014 passage of Proposition 2 did strengthen California’s Rainy Day Fund to some extent. It mandated that the state set aside 1.5% of the General Fund and capital gains revenue in excess of 8% of the General Fund (until the

Editor’s note: This is an extract from a recent Evercore Wealth Management publication. To view the full paper, please visit www.evercorewealthmanagement.com.
Rainy Day Fund is equivalent to 10% of the General Fund).

State leaders could allow Proposition 30's tax rates to expire as scheduled or they could extend the measure beyond 2018. One major issue is how to balance the progressivity and the volatility of the revenue system. By raising rates on the wealthiest Californians, Proposition 30 has made the revenue system more progressive, while also contributing to its volatility, as there are relatively few individuals who generate significant earnings not only from salary but also from capital gains. By placing a greater burden on the resident rich in this manner, California’s revenues will rise and fall with the equity market (and plunge if many members of this demographic leave the state).

The municipal market has recognized the progress made by the state based on trading values for 5- to 10-year, non-callable, State of California general obligation debt compared to the MMD AAA-scale, according to data from Loop Capital Markets. At the widest spreads in 2009, the state was in abysmal financial shape. A voter initiative to raise taxes, similar to Proposition 30, failed miserably. California was also running record deficits and had to resort to delaying payments to local governments, state employees and vendors to manage its cash flow crisis during one of the worst recessionary periods in the state's history.

The state’s revenues, which have a propensity for wide swings in performance, mean that the forecasted tax collections aren't reliably sustainable, and investors, as well as voters, will have to weigh the potential impacts of this and other propositions in the context of future recessions along with today's relatively robust environment. The hard-fought fiscal alignment achievements of the past five years could be easily eroded, exposing Californians to more political and financial uncertainty.

We remain reasonably confident that California will retain its recent fiscal discipline and that the state and most local entities will manage their long-term liabilities while finding new revenue sources to address capital needs. We continue to research and purchase a variety of state and local credits that help provide appropriate risk/return rewards for our clients.

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Gaining Ground in Volatile Markets

By Chris Zander

Patience and perspective are keys to riding out volatile markets. This isn’t usually the best time to make substantive changes to long-term plans, but it can be a great time to adjust tactics – to adjust investment portfolios and wealth transfer strategies in ways that can add up to significant tax savings.

Tax loss harvesting should be a staple play, but is often overlooked by investors. By realizing short-term or long-term capital losses now and reinvesting in similar assets, opportunistic tax loss harvesting allows investors to remain fully invested in the market while offsetting gains taken earlier this year, or carrying forward the capital loss to future years when gains may be present. The tax savings can be considerable.

For example, shares in Exxon stock that were bought for $50,000 but subsequently slid 20% along with other integrated oil companies, could be sold to harvest the $10,000 capital loss and offset $10,000 worth of capital gains achieved in the same tax year. By purchasing shares in Chevron, say, the investor also maintains similar market exposure.

Investors must not reinvest the proceeds in what the IRS deems substantially identical securities within 31 days. Otherwise, the transactions will be considered a “wash sale” and the loss would be disallowed. Selling a specific company stock, for example, and buying another in the same sector might be a good tax loss harvesting move in this market; selling one S&P 500 index fund to buy another might be deemed a wash sale.

It’s worth considering tax loss harvesting in the event of an inheritance; securities received typically receive a step-up in income tax basis at death. If that happened in the last few years, it is possible that the securities have unrealized capital losses.

Charitable giving in volatile markets is more complex, as it raises a number of important planning considerations. Making gifts of appreciated securities throughout the year allows investors to diversify and rebalance in a tax-efficient and timely manner. Given the recent stock market declines, however, this might be a good time to defer giving or to satisfy philanthropic goals with disbursements from donor advised funds or foundations that can be replenished in future years with appreciated securities.

Periods of market decline can provide a real opportunity to execute wealth
transfer strategies using depressed assets, including securities, real estate and private businesses. Continued low interest rates also enhance the outcome of successful estate freeze transactions, such as grantor retained annuity trusts, or GRATs, sales to intentionally defective grantor trusts, charitable lead annuity trusts, and intra-family loans.

GRATs can also afford significant transfer tax savings. Investors holding concentrated positions in low-cost securities can consider establishing a GRAT and funding it with stock. If the stock outperforms the IRS hurdle rate (currently 2% for trusts established in October 2015) over the term of the trust, the excess growth can flow to the beneficiary of the trust free of transfer taxes. Here’s how that works: An individual who holds a concentrated low-cost stock position in, say, Apple stock and makes a gift of $2 million of that stock to a zeroed-out GRAT with a term of three years will, if the stock recovers and earns the equivalent of a 15% rate of return annually over the next three years, receive back $2,080,516 worth of Apple stock in-kind with $633,553 worth of Apple stock passing to his or her children, free of all estate and gift taxes.

For investors who established a GRAT with a stock at a much higher valuation, say Apple two years ago, the trust may now be in danger of failing to meet its objective. In this case, the grantor can use other assets to substitute into the GRAT, taking back the Apple shares to a fund a new GRAT at a much lower initial price. This new GRAT will have a much better opportunity to outperform the hurdle rate. The assets used to substitute into the original GRAT will continue to be invested and likely will revert back to the grantor in the form of the fixed annuity payments. So, no harm, no foul.

Investors considering the transfer of real estate or private equity investments as part of wealth transfer and succession planning strategy also have options in these market conditions. Uncertainty may impact independent valuation appraisals of those assets and make them more attractive for gifting purposes. Since these valuation appraisals are performed looking at the underlying assets of these funds, along with a projection of the current market environment, they may now be lower for gift tax purposes, using less of their gift tax exemption.

Those who have already established grantor trusts that have private equity, real estate and other private investment commitments requiring periodic capital calls, or follow-on investments, may wish to consider making loans at current low interest rates so that the trusts do not need to sell other securities haphazardly to fund capital calls.

Last, but certainly not least, retirement planning also deserves another look in these markets. Investors considering a conversion of a traditional IRA to a Roth IRA may benefit from declines in investment values, as the associated income tax liability, or the cost to convert, could be lower. Those who recently made this conversion may not have missed the boat: The IRS allows for a recharacterization of that transaction for those who incurred a tax liability on a much higher IRA value.

Market volatility can be uncomfortable, and it’s important to retain a long-term focus. There are as many variables and considerations as there are people impacted, and interested investors should work closely with their wealth advisors. It may be that tactical changes, even if they seem small now, can significantly enhance a family’s long-term wealth and legacy.

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1 Only if the grantor survives the term of the GRAT.
2 A “zeroed-out” GRAT is structured with a stream of annuity payments that have a present value equivalent approximately to the value of the initial gift. This results in little to no taxable gift upon funding.
3 Assumes that annuity payments are made using shares of Apple in-kind and there is no income tax event.
4 This must be completed by the last date, including extensions, for filing or refile prior-year tax return, typically on October 15.
Editor’s note: This is an extract from a briefing sent in early October to Evercore Wealth Management clients. Wealth planning is tailored to the unique circumstances of each individual and family.

**CAPITAL GAINS/LOSSES**

While it may be beneficial to harvest capital losses within an individual portfolio by December 31, it is important to review capital gains and losses across all investment portfolios, including business assets, LLC or partnership interests, and gains on the sale of any real estate. By realizing capital losses and reinvesting the proceeds into the same general asset class, investors can use the capital losses this year but still remain invested in the market. These capital losses can be used to offset gains taken earlier in the year or carried forward to future years. One caveat: Investors must not reinvest in what the IRS deems “substantially identical securities” within the next 31 days, which would result in a wash sale and a disallowance of the loss for income tax purposes.

For portfolios inherited from recently deceased individuals, it is possible that the securities inherited may now have an unrealized capital loss since the decedent may have received a step-up in income tax basis at death (which resets the cost basis for tax purposes at the fair market value on the date of death).

**CHARITABLE GIVING**

Specific recordkeeping requirements must be satisfied to deduct any donations made to a charity. Donations made by check must be mailed by year-end to secure a federal income tax deduction for the fiscal year.

Given current income tax rates, individuals should consider charitable contributions using qualified appreciated stock. If the shares have been held for more than one year, the current fair market value of the securities contributed (subject to certain AGI limitations) can be deducted while avoiding the capital gains tax due on the appreciation if the asset was otherwise sold.
Investors with longer-term philanthropic objectives who would also benefit from a larger charitable deduction for the year may want to consider establishing a private foundation or donor advised fund. These vehicles allow donors to make a larger gift today and achieve current income tax planning objectives while deferring identification of the ultimate charity. Charitable remainder trusts may also be a solution for those who would like to diversify an appreciated stock position, receive a charitable income tax deduction, and retain a tax-efficient income stream for life while providing for a charity at death. However, with recent declines in equity prices, investors may wish to consider the timing of their contribution.

**GIFTS AND WEALTH TRANSFER**

The lifetime federal gift, estate and generation-skipping tax exemption increased to $5,430,000 in 2015 from $5,340,000 per individual. Individuals who utilized all of their exemption in 2014 can make a gift of an additional $90,000 exempt from federal estate, gift, and generation-skipping tax.

Annual exclusion gifts allow individuals to give up to $14,000 per year to anyone without incurring gift tax (married couples may give up to $28,000). Parents or grandparents may also want to consider additional tax-free gifts in the form of direct payments for health insurance premiums, medical expenses or school tuition. These payments must be made directly to the applicable institution.

For those who have fully utilized the above exclusions (or are only interested in transferring the future appreciation on their assets and not the principal), low interest rates and recent declines in asset values make this a still opportune time to implement certain estate freeze planning strategies. Intra-family loans, grantor retained annuity trusts, or GRATs, and charitable lead annuity trusts, or CLATs, are all popular strategies that may be particularly attractive in today’s low interest rate environment, depending upon the overall wealth planning objectives.

**EDUCATIONAL PLANNING**

529 College Savings Plans may be an effective strategy for setting aside funds for college expenses for children, grandchildren or other potential beneficiaries. 529 Plan limits are set by individual states, and the federal gift tax rules apply to contributions. Contributions are not deductible for federal income-tax purposes (although they may be deductible from state income tax). Distributions used to pay qualified tuition expenses are tax-free. By timing a gift tax return, individuals can accelerate giving, use annual exclusion gifts for the next five years, and make up to a $70,000 contribution (or a joint $140,000 contribution with his or her spouse). The owner, or contributor, of the 529 Plan may also change beneficiaries or withdraw assets (subject to a penalty) in the future, should circumstances change.

**TRUST DISTRIBUTIONS**

Non-grantor trusts are subject to the highest income tax rates and Medicare surtax income above the threshold amount of $12,300. For discretionary trusts, trustees (or their advisors) will need to determine if the income should be paid out or accumulated for tax reasons, while taking into consideration the purpose of the trust and the needs of the current and future beneficiaries.

**IRA REQUIRED MINIMUM DISTRIBUTIONS**

IRA owners who turn age 70½ during 2015 have until April 1, 2016 to take their first required minimum distribution and must take the second by December 31, 2016. Owners already taking distributions must take their annual required minimum distributions by December 31, 2015.

**IRA AND RETIREMENT PLAN CONTRIBUTIONS**

The maximum contribution amount for both traditional IRAs and Roth IRAs is $5,500 for 2015 (subject to eligibility requirements). Contributions may be made until April 15, 2016 and still be counted for the 2015 tax year. Individuals age 50 and over are eligible to make an additional $1,000 catch-up contribution.

The maximum salary deferral limit for 401(k), 403(b), and 457 plans in 2015 is $18,000. Individuals age 50 and over may contribute an additional $6,000 per year.

Individuals with self-employment income may also consider establishing a SEP-IRA or Defined Benefit Pension Plan, which may permit a higher tax-deferred contribution level.

**BENEFICIARY DESIGNATIONS**

This is an excellent time to review beneficiary designations for IRAs, qualified plans, and life insurance policies. The distribution of these accounts is determined by the beneficiary form, not by the individual’s will. Beneficiary designations should generally be individuals, not an estate, and should include primary and successor beneficiaries. There may be reasons to consider trusts, though careful drafting is essential. Individuals with testamentary charitable bequests should consider using IRAs or qualified plan beneficiary designations to appoint these assets to charity, for both income and estate tax savings. Finally, life changes such as birth, divorce, and death also necessitate modifications to beneficiary designations.

Please contact your wealth advisor or Jennifer Tse at tse@evercore.com to discuss these topics.
Educating the Next Generation

By Michael Cozene

Children who grow up in an affluent household can encounter mixed feelings, mixed messages and mixed blessings. Enchanted lifestyles and large inheritances can fuel dysfunction, paralyze and strip children of ambition and meaning. Some children suffer feelings of guilt over not having earned the wealth; others find themselves caught in a web of entitlement.

This price of privilege is a potential concern for growing numbers of American families. With more than $1 trillion expected to flow from one generation to the next on average over each of the next 50 years, it can give even the most confident parent or grandparent pause to consider that 70% of wealth transfers fail, with the heirs dissipating wealth. About 60% of these failures result from a breakdown of communication and trust within the family unit, and another 25% of the failures are attributed to inadequately prepared heirs. Estate planning and investment management are key to successful transfers, but overlooking the softer elements can undermine even the best-laid technical plans.

Preparing heirs to be good stewards and thoughtful administrators of wealth significantly increases the odds of sustaining and growing wealth across generations. Unfortunately, these skills are not being taught at the prep school or college level. Nor, in many cases, are they being taught at home.

According to a Jump$tart Coalition for Financial Literacy survey, 80% of parents believe that their children learn everything they need to know about money in school, while 90% of students say whatever they know about money they learned from their parents. This disconnect underscores the need for heirs to gain competencies in personal money management, saving and investing, wealth preservation, and philanthropy.

While each situation is unique, we generally find that people wait too long and share too little, out of fear of doing harm. But children know more about their family’s wealth than parents may realize. Parents who communicate more, rather than less, and sooner, rather than later, are more effective at educating their children to be successful inheritors. Sharing information is also an opportunity for the parent to listen and to learn from the next generation.

Ideally, families will employ what has been described as a “drip, drip, drip” method of education. Constant communication between parents and other relatives with the children as they grow is the best way to provide a practical education and shared values.

We all know that our children learn best from example; bringing children to the

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1 Boston College Center on Wealth and Philanthropy
2 The Williams Group

$1 Trillion

in annual wealth transfer forecasted
office and sharing what the writer Alain de Botton describes as the sorrows and pleasures of work can be a formative and wonderful experience. In a similar vein, establishing an allowance can help children learn to differentiate between needs and wants. So too can early efforts at saving and giving to charities; many parents and grandparents report becoming absorbed in the children’s passions, even as the children absorb the family’s values. A shared commitment to saving elephants, to take one client example, brings the family together and teaches the youngest members a great deal about global economics and politics (and the oldest members a thing or two they might not have known about their children’s generation, or elephants, for that matter).

As the children grow, more formal educational programs and mentoring structures can ensure financial literacy and prepare young adults for the challenges, as well as the opportunities, of both work and wealth. Adult children who know who they are and what they want out of life should probably be full participants in family discussions about wealth.

It is unfortunate that wealth can become such a divisive force in many financially successful families, especially when the creators of the wealth worked so hard in large part to provide for their families. It doesn’t have to turn out that way, however. Communication, education, and, as necessary, intervention can help make wealth a force for good, across the generations, creating a positive, lasting legacy for the family.

At Evercore Wealth Management, we provide educational programs on wealth transfer that bring together like-minded individuals, couples and families to consider specific topics, including financial education, socially responsible investing, impact investing and special needs trusts. We also provide customized services, working directly with families to help prepare next-generation inheritors to manage their wealth in the broader context of their own accomplishments and goals.

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Around this time seven years ago, I was very excited. I had been working on creating a new wealth management firm for most of the year and had recruited a dozen former colleagues from U.S. Trust to become the founding partners of Evercore Wealth Management. We were scheduled to launch our new venture in a few weeks, after the vacation I had promised my wife, knowing that we would be working flat out once our doors opened.

### A good run

**Historical number of days without a 10% drop in the S&P 500**

Source: Bloomberg as of February 20, 1928 to August 31, 2015.
Although economic storm clouds created by the subprime credit crisis were all around us, I was hopeful that the government would help Lehman Brothers find a partner, as it had for Bear Stearns, and that we would avert a global liquidity crisis. When we arrived in Positano, however, we learned that Lehman had filed for bankruptcy.

My wife and I had a keen interest in the developments, on behalf of my soon-to-be new partners and their clients, and for ourselves, as most of our own assets resided in accounts at Lehman Brothers Trust Company. I had entered my 60s, and we knew that it becomes more difficult to replace lost assets as we age. As the situation unfolded, I relied on my years of experience for guidance.

I knew that assets held at a trust company are not subject to the claims of creditors of the firm, but there is nothing like a real crisis to prove the law. The law was correct, and our assets were not impaired. I was less concerned about our balanced portfolio withstanding a drawdown, although I didn’t foresee that the S&P 500 Index would register a drawdown of close to 50%. That experience helped shape some of the guiding principles that my partners and I established for Evercore Wealth Management.

First, the safety of our clients’ assets is paramount. We recommend that our clients custody their assets at Evercore Trust Company, N.A., which segregates them from the firm’s assets so that they are not subject to claims of our creditors, in accordance with the law.

Also, we decided that standard measures of volatility were not sufficient for our clients; after all, our generation had experienced three statistically impossible market events. That is why we prefer to discuss drawdown risk in client portfolios in terms of dollars, as well as probability. We believe that our clients should be aware that circumstances similar to 2008 can occur again, and we want to make sure that they can live with the potential risk of a meaningful drawdown.

We work directly with our clients to prepare a lifestyle analysis, laying out a long-term plan based on our return assumptions, proposed asset allocation, and our clients’ spending requirements. That’s relatively straightforward in a strong market, but in a low-return environment, we often have to make harder choices between return and risk. Sometimes we express the choice, somewhat facetiously, as between eating well or sleeping well. If this summer has cost you sleep because of market volatility, it may be time to

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It becomes more difficult to replace lost assets as we age.
revisit your lifestyle analysis to make sure your asset allocation remains appropriate for your required return, level of risk tolerance, and age.

As illustrated in these charts, times have changed. From October 3, 2011 until May 21, 2015, for some 1,326 days and a total cumulative return of 93.8%, the S&P 500 did not experience a 10% drop. Now, we have seen volatility return to the markets. Since 1980, the S&P 500 has averaged intra-year drawdowns of 14%. It takes on average 30 days to recover from drawdowns in the 5%-10% range, 53 days to recover from drawdowns in the 10%-15% range, 72 days to recover from drawdowns in the 15%-20% range, and 1,081 days to recover from drawdowns 20% and greater. Most recently, it took 1,604 days for the market to recover from the Great Recession.

**Make sure your asset allocation remains appropriate for your required return, level of risk tolerance, and age.**

We launched our firm, just a few weeks later than we originally planned and in the middle of the Great Recession. Our clients who kept to their asset allocation throughout that period have more than recovered the drawdown. Periods of volatility do pass, but there is no question that drawdowns can cause discomfort, especially for those of us with less time to recover from losses. Our goal is to work with our clients to achieve a balanced asset allocation and to make sure they can live with potential drawdowns.

**Jeff Maurer** is a Partner at Evercore Wealth Management and the Chief Executive Officer. He can be contacted at maurer@evercore.com.

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**Perspectives on Wealth**

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**Drawdowns can cause discomfort**

**S&P 500: 1980-2015 Calendar Year Returns vs. Intra-Year Drawdowns**

<table>
<thead>
<tr>
<th>Year</th>
<th>Max Intra-Year Drawdown</th>
<th>Calendar Year Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>-12%</td>
<td>-4%</td>
</tr>
<tr>
<td>2014</td>
<td>-6%</td>
<td>11%</td>
</tr>
<tr>
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<td>-6%</td>
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<td>1980</td>
<td>-17%</td>
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</tr>
</tbody>
</table>

Percentage Returns

Source: Bloomberg

Note: Return data all expressed as price returns. 2015 calendar year return and max intra-year drawdown is as of August.
Decoding Illiquid Alternatives

By Stephanie Hackett

Many of the portfolios that we manage have a 5%-10% allocation to illiquid alternatives, as these investments are expected to generate strong returns relative to traditional asset classes. We seek opportunistic funds and managers that we believe have the potential to outperform public markets by at least 500 basis points, to provide a premium that compensates investors for their lack of liquidity.

Risk is managed through manager selection and selective allocations.

An optimal allocation will have exposure to multiple sub-classes and strategies, and diversification across vintage years, industry sector, stage of investment and geography. As with any investment, including illiquid alternatives should be evaluated in the context of individual risk tolerance, liquidity needs and investment horizon. Two of the critical factors are (I) investment strategy and (II) vehicle structure.

Editor’s note: This is the second installment in a series of discussions on investing in illiquid alternatives. The first, Selecting & Managing Illiquid Alternatives, can be viewed at http://evercorewealthmanagement.com.

I. INVESTMENT STRATEGY

Illiquid alternatives is an umbrella term for different types of investment strategies that can range from private equity, to illiquid credit, to investments in real assets such as real estate and infrastructure projects. Strategies are generally categorized based on the stage of investment or types of underlying assets.

PRIVATE EQUITY

Venture Capital

- Venture Capital, or VC, funds provide capital for promising start-up companies with high growth potential that have a new technology, product, concept, or business model. Investments can be in seed stage, early stage, late stage, and pre-IPO stage businesses. Facebook, which became public in 2012, is a classic example.

- Capital funding can be used to test a concept or to launch, develop or expand a business.

- VC firms generally take a minority ownership position (10%-30%) in companies.

- VC is a high risk/high potential reward investment, and the percentage of failures among venture-backed firms is very high. VC funds typically invest in a large number of deals (10-15+) in the hopes that one or two will drive the overall fund’s returns.

Growth Capital

- These are investments in slightly later stage companies, usually with proven concepts/products that are looking to grow their operations. Most growth companies already generate revenue and may be cash flow positive, but need additional funding to expand.

- Capital can be used to scale-up operations, enhance distribution, expand geographically, develop a new product, or finance an acquisition. Growth capital is generally a minority equity investment (10%-40%).

- The general partner typically provides financial capital as well as strategic guidance and operational support.

Buyout

- These invest in mature companies that already generate significant cash flow. Equity capital is often used for acquisitions and/or refinancing transactions.

Editor’s note: This is the second installment in a series of discussions on investing in illiquid alternatives. The first, Selecting & Managing Illiquid Alternatives, can be viewed at http://evercorewealthmanagement.com.
• Buyout firms acquire a controlling interest, generally 100%. Most transactions are made using both debt and equity, with the debt portion usually accounting for 50%-85% of the purchase price.
• The general partner has significant influence over the timing, terms and conditions of their investment. Many general partners are also active in trying to create value in the businesses, serve on the Board of Directors, and are involved in all major strategic decisions for the company.

ILLIQUID CREDIT
Special Situations/Distressed
• These are investments in financially or operationally distressed companies through the purchase of debt or equity as part of restructuring.
• Distressed companies are often fundamentally good businesses but are undergoing challenges, such as out-of-control expenses, a new or formidable competitor, or an unsound capital structure.

• There are typically two approaches in distressed investing:
  - Control-oriented approach – A fund acquires a large position in the debt securities of a distressed company to secure a control position in bankruptcy proceedings. The general partner takes an active role in the restructuring.
  - Restructuring/turnaround approach – A fund infuses new equity into a company to take control of and restructure the company. American Apparel, for example, is currently a private equity target.

Mezzanine Debt
• These are subordinated debt or preferred equity investments. They provide high-yield debt to reasonably mature companies that generally have positive earnings and cash flow, but need additional capital for acquisition or refinancing transactions.
• Mezzanine debt is a hybrid instrument that usually has an equity component (e.g., a warrant) attached.

REAL ASSETS
Real Estate
• Equity and/or debt investments in office, retail, residential and other properties. Strategies include:
  - Core Properties: Funds generally invest in stable, fully leased multitenant properties within strong, diversified metropolitan areas.
  - Core Plus: Funds generally invest in core properties, although many of the properties will require some form of enhancement or value-added element.
  - Value Added: This strategy involves buying a property, improving it in some way, and selling at an opportune time for a gain. Properties are considered value-added when they exhibit management or operational problems, require physical improvement, and/or suffer from capital constraints.

5-10%
recommended illiquid allocation

Getting in Early, or Later
Private equity and the life cycle of a private business
- **Opportunistic**: A high-risk/high-return strategy. The properties will require a high degree of enhancement. They may also involve investments in development, raw land, mortgage notes, and niche property sectors.

**Energy**
- These are investments in the energy sector at various stages.
- Targets include oil and gas, power generation, pipelines, energy services, and renewables.

**Infrastructure**
- These are investments in public infrastructure, such as roads, bridges, tunnels, toll roads, airports and mass transportation.
- These investments are popular in emerging markets due to the high demand for infrastructure.

### II. VEHICLE STRUCTURE

Equally important to selecting the investment strategy is the structure of the investment vehicle. Most illiquid alternative investments are structured as privately managed pools of long-term capital. These pools then invest in companies or securities that are privately held and/or illiquid. Certain structures, such as a single fund investment or co-investment, can be highly focused on a particular niche sector, while others, such as fund-of-funds or secondary funds, are broadly diversified across strategies.

**Single Fund Investment**
- Investors, known as the limited partners, commit capital to a fund, which then deploys the capital over a multiyear period.
- The fund manager, known as the general partner, has specialized areas of expertise, such as a particular strategy, industry or geography. General partners add value to the companies that they invest in by monitoring management, serving on the Board of Directors, and contributing to major strategic decisions.
- The typical holding period for each company investment is 4-6 years. Invested capital plus any gains are distributed to the limited partners after investments are sold.
- Private equity and real estate funds typically invest in 8-10 companies, while venture and credit strategy funds usually invest in a more diversified portfolio of 10-25 companies/securities.
- General partners typically raise a new fund every 3-5 years.
- Funds usually take 8-10 years to return all capital to limited partners.
- Fees range from 1.5%-2.5% management fee plus 15%-25% carry.

**Fund-of-Funds Investment**
- A fund-of-funds invests in a pool of other private equity funds, or a combination of funds, secondaries and co-investments.
- This approach allows for diversification across sectors, stage of investment, and geography. A fund-of-fund often has access to top-tier fund Managers. Fund-of-funds raise new funds every 1-3 years. A fund-of-fund usually takes 8-12 years to return all capital to limited partners.
- Fees include the management fees and carry of the underlying funds, plus an additional 1.0%-1.5% management fee and 5%-15% carry for the fund-of-funds manager.

**Co-Investments**
- Co-investments in a privately held company allow investors to participate alongside a general partner in a portfolio company. Some general partners offer co-investment rights to their limited partners on select portfolio companies, typically for larger deals that require more capital than the fund can provide.
- The typical holding period is 4-5 years.
- There is usually no management fee, and a carry of 0%-10%.

**Secondary Investments**
- Fund interests are purchased from existing limited partners who are seeking liquidity from primary commitments.
- Secondary interests are often sold at a discount to current net asset value. The discounts vary based on supply/demand of the market and the complexity of the transaction.
- Secondary funds are often broadly diversified across strategy, sector, geography and vintage year. They usually return all capital in 4-8 years.
- Fees include the management fees and carry of the underlying funds, plus an additional 1.0%-1.5% management fee and 5%-15% carry for the secondary fund manager.

At Evercore Wealth Management, we are currently focused on illiquid alternative managers or funds that have broad, diversified platforms and are adept at allocating across multiple strategies where they see the most attractive opportunities. We also prefer to invest with select managers who can actively add value to the businesses they invest in by providing strategic advice and guidance, rather than simply providing passive capital and/or financial leverage. We believe these managers will be better positioned to generate attractive returns in uncertain economic landscapes.

Stephanie Hackett is a Managing Director and Portfolio Manager at Evercore Wealth Management. She can be contacted at stephanie.hackett@evercore.com.

evercorewealthmanagement.com
Thoughtful Giving - and Receiving

By Ashley Greeff

Millennials are arguably better equipped to inherit or receive financial assistance from their parents or grandparents than preceding generations. Their formative experiences, from the dot.com crash to the Great Recession, have made them relatively risk averse, for better and for worse.

Born between the early 1980s and the early 2000s, Millennials, also known as Generation Y or the Net Generation, have struggled to gain employment. Many were forced to return to their parents’ homes after college and take low-paying jobs. The improving economy of the past seven years has obviously helped, but many economists believe that this generation has lost time and money that it may not recover.

The result is a generally conservative view of money that is attractive in some ways – Millennials as a group expect to work hard and may be less likely to squander an inheritance than their parents were at the same age – but it also carries its own risks. Getting stuck in a dead-end job, putting off homeownership, and avoiding the markets have financial opportunity costs. And the long-term emotional costs of delaying travel, marriage and children are more significant still.

Understandably, many parents and grandparents want to help, but they worry that assistance won’t help to create financially responsible adults or that it will bring about dependence and lack of motivation. At the same time, Millennials who are fortunate to receive an inheritance might not feel ready for the risk and responsibility that comes with it.

Communicating these concerns can benefit the family as a whole. Properly managed, financial assistance to young adults could enable them to invest in themselves, whether through experiential traveling, further education or starting their own business. Individuals could pay off or avoid crippling credit card debt and instead contribute to retirement accounts for long-term compounding or buy a house in this low-interest rate environment.

Every case is unique and the decisions have to be made in the context of the family relationships, as well as financial and other considerations. Certainly, the beneficiary of financial assistance should be charged with the task of treating the money in the same spirit with which it was given, perhaps mindful of future generations as well.

From those to whom much is given, much can be expected. With proper, strategic planning and investing, having the financial assistance can help a young adult set the stage for a healthy, responsible financial life.

Ashley Greeff is a Vice President and Wealth Advisor at Evercore Wealth Management. She can be contacted at greeff@evercore.com.