Committed to meeting our clients’ financial goals, and to earning and sustaining their trust

For more information, please visit www.evercorewealthmanagement.com
A Message from the CEO

As investors weighted to the United States, we are happily having a less eventful summer than those with heavy exposure to Europe and China. We are nevertheless mindful that rising volatility after six years of easy U.S. monetary policy may mean more challenging times ahead.

The S&P 500 Index has gained 7.4% in the 12 months since June 30, 2014, and 17.8% on an annualized basis since January 30, 2009, shortly after we opened our doors. Our core equity portfolio has done even better, up 12.2% in 12 months and 19.9% annualized in that six-year plus period on a gross basis. It’s been a great run, but we know that we cannot expect these returns from stocks going forward, unless we see more tangible signs of improved economic stability.

We have therefore adjusted our capital market assumptions to project a 7.4% return on equities, down from the earlier expectation of 8.5%, and a 6.1% return for our balanced portfolio, down from 7%. We have also reduced our inflation assumption to 2% from 2.2%.

We are not reducing our allocation to equities, however. This cycle may have some room to run and, as our Chief Investment Officer John Apruzzese discusses in this issue of Independent Thinking, innovation is continuing to drive some extraordinary changes in the way we work and live. A number of companies, notably in the United States, should benefit from improved productivity. (See also Wealth Advisor Iain Silverthorne’s article on the role of technology in wealth management, on page 14.)

To the extent that our client portfolios are now overweight in equities, we are trimming back the exposure to the original allocation and, with the proceeds, investing in non-correlated and illiquid assets, our approach to which is described by Portfolio Manager Stephanie Hackett on page 6.

In discussions with our clients about the wealth planning aspects of this change, we find that they value our realistic and relatively conservative market return assumptions. This line of attack is, unfortunately, rare in the wealth management business, but we know that it is important to show the full impact of market drawdowns, taxes, investment fees, and rising risk. That’s how we can best help our clients plan, spend, and invest appropriately to meet their long-term financial goals.

Finally, it’s worth noting that a low-return market affects everyone but has particular ramifications for those approaching or already in retirement. I take a look at the implications for my own generation in my regular Baby Boomer column on page 18.

Please contact any of us at Evercore Wealth Management to discuss our current market outlook and related wealth planning issues, or with any other questions or concerns you may have. As always, we welcome your views.

I hope you and your family have a healthy and happy summer.

Jeff Maurer
Chief Executive Officer

evercorewealthmanagement.com
Investing in Thin Air

By John Apruzzese

Radically easy monetary policy across the developed world, commonly known as quantitative easing, has successfully reflated all major asset classes, including equities, but has so far failed to boost economic growth to levels desired by policy makers and investors. It is time to reconsider our long-term return expectations for both stocks and bonds, and to increase our exposure to uncorrelated and illiquid assets.

We have lowered our 10-year annualized expected returns on a balanced portfolio to 6.1% from 7%. This reflects our reduced expectations for public equities, now 7.4% down from 8.5%, in recognition of the high relative valuation of the market, which is currently 10% to 20% higher than the long-term average valuation to which we anticipate the market will eventually revert. In other words, to the extent that the equities in a client portfolio have increased faster than the rest of the portfolio, we are balancing back to the original allocation.

We are not reducing the allocation to equities beyond that, however. Stocks can remain at elevated valuation levels for extended periods of time, particularly in periods of low interest rates. We would need to see a significant tightening of global monetary policies or evidence of recession in the United States to make a tactical change in our equity allocation, neither of which is in evidence.

At the same time, we are increasing our allocation to our diversified market strategies and illiquid alternative asset classes with the proceeds from the equity rebalancing. Diversified market strategies hold out the possibility of boosting portfolio returns during difficult periods for the equity and bond markets because they are exposed to risks and returns that are largely unrelated to the direction of the major markets. Illiquid alternatives are investments in inherently inefficient markets, such as private equity and private real estate, which allow for the possibility of returns significantly higher than average returns when investing with top quartile performers.

Longer term, high equity valuations need to be supported by strong economic growth. Unfortunately, dwindling population growth in general, and labor force growth in particular, take a major driver of growth off the table. Even inflation, despite the efforts of central bankers in developed countries around the world to reflate their economies, is not much help in terms of nominal economic growth.

That leaves productivity — the most important driver of economic growth and the only one that matters when it comes to real per capita growth. It is an interesting conundrum, however, that reported productivity is running below long-term historical averages (1.4% over the last 10 years versus 2% over the last 30), and yet we see anecdotal evidence of productivity...
Reducing Long-Term Return Expectations

10-year Expected Returns

<table>
<thead>
<tr>
<th></th>
<th>March 2014</th>
<th>March 2015</th>
<th>After-Tax¹</th>
<th>After-Tax Real⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Previous Pre-Tax¹</td>
<td>Pre-Tax²</td>
<td>After-Tax¹</td>
<td>After-Tax Real⁴</td>
</tr>
<tr>
<td>Cash</td>
<td>2.2%</td>
<td>2.2%</td>
<td>2.2%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Defensive Assets</td>
<td>3.2%</td>
<td>2.8%</td>
<td>2.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Credit Strategies</td>
<td>5.9%</td>
<td>5.5%</td>
<td>3.1%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Diversified Market Strategies</td>
<td>6.7%</td>
<td>5.7%</td>
<td>3.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Growth Assets</td>
<td>8.5%</td>
<td>7.4%</td>
<td>5.6%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Illiquid Alternatives</td>
<td>15.0%</td>
<td>12.2%</td>
<td>8.7%</td>
<td>6.7%</td>
</tr>
<tr>
<td>Balanced Portfolio⁵</td>
<td>7.0%</td>
<td>6.1%</td>
<td>4.6%</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

¹ “Previous Pre-Tax” returns as of March 2014
² “Pre-Tax” returns as of March 2015
³ “After-Tax” returns assumption as of March 2015 are as follows:
   a. Cash & Defensive Assets: no tax
   b. Credit Strategies: ordinary income tax of 43.4%
   c. Diversified Market strategies: blended rate of 25% long-term capital gains (23.8%) and 75% ordinary income (43.4%)
   d. Growth Assets: ordinary income tax of 43.4%
   e. Illiquid Alternatives: blended rate of 75% long-term capital gains (23.8%) and 25% ordinary income (43.4%)

⁴ “After-Tax Real” reflects returns after taking out projected inflation rate of 2.0% as of March 2015
⁵ Balanced Portfolio pre-tax and after-tax returns assume the following asset allocation:
   a. Cash: 2.0%
   b. Defensive Assets: 23.0%
   c. Credit Strategies: 7.0%
   d. Diversified Market Strategies: 12.0%
   e. Growth Assets: 51.0%
all around us. Just think about how that smartphone in your hand has changed how you work and live – and that may be just the beginning. We may be on the cusp of a technological revolution that will rival its industrial equivalent in its impact.

Voice recognition, artificial intelligence and robotics are advancing at an accelerating pace. Driverless cars and drones could transform our lives, as our smartphones already have, and provide enormous new opportunities for investment. The cost curves for wind and solar energy production are threatening to fall below the cost of fossil fuel and continue to drive lower. And the payoff from decoding DNA is on the verge of coming to fruition. It may be that economists are underreporting productivity. While we remain diligent in rebalancing among our asset classes, to ensure that we are not overweight equities as an asset class, we continue to invest with conviction in companies that are driving positive and sustainable changes, and those that stand to benefit from these advances in technology.

We believe that we are building well-balanced portfolios that will protect our clients’ capital and benefit from opportunities in a low-return world.

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

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### Estimating Expectations on Equity Returns

#### Domestic Equities 10-year Expected Returns

<table>
<thead>
<tr>
<th></th>
<th>Annualized Historical Data¹</th>
<th>EWM Estimates</th>
<th>30 Years</th>
<th>10 Years</th>
<th>Projections²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>2.1%¹</td>
<td>2.9%</td>
<td>1.7%</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td>Labor force growth</td>
<td>0.5%</td>
<td>1.1%</td>
<td>0.5%</td>
<td>0.5%</td>
<td></td>
</tr>
<tr>
<td>Productivity</td>
<td>1.6%</td>
<td>2.0%</td>
<td>1.4%</td>
<td>1.6%</td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>2.0%</td>
<td>2.2%</td>
<td>1.8%</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>4.1%³</td>
<td>5.1%</td>
<td>3.5%</td>
<td>4.0%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P EPS Growth – Nom GDP Growth</td>
<td>2.2%¹</td>
<td>2.2%</td>
<td>2.3%</td>
<td>6.1%⁶</td>
<td></td>
</tr>
<tr>
<td>Valuation Differential</td>
<td>-0.8%</td>
<td>1.7%</td>
<td>-0.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yield</td>
<td>2.0%</td>
<td>2.4%²</td>
<td>2.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Total Return

|                    | 7.4%³ | 11.3%⁸ | 7.7%¹⁰ | 12.0%¹¹ |

---

¹ Source: Bloomberg. Labor force growth, productivity, Real GDP, inflation & Nominal GDP represent respective annualized growth over the indicated time period, ending December 2014.
² We do not project any changes in valuations for forward looking estimates.
³ EWM Estimate for Real GDP represents the sum of labor force growth and productivity, derived from Bureau for Labor Statistics and Congressional Budget Office projected data; summation discrepancy due to rounding error.
⁴ EWM Estimate for Nominal GDP represents the sum of Real GDP and Inflation.
⁵ EWM Estimate derived from the Compound Annual Growth Rate of the difference between the S&P Earnings Growth Rate and Nominal GDP, measured annually over 30 years ending December 2014.
⁶ FactSet median estimate for EPS LTG on the S&P 500 Index is 10.1%, implying a differential of S&P EPS Growth over Nominal GDP Growth of 6.1% after subtracting projected Nominal GDP growth of 4.0%.
⁷ Valuation Differential represents the difference between the observed Total Return and the remaining economic components consisting of Nominal GDP, the difference between S&P EPS Growth and Nominal GDP Growth, and the yield (see note 8). Given that we expect current valuations to revert back to the long-term mean, the valuation differential reflects the 30 year average of the Trailing, Forward, and Schiller S&P 500 P/E ratios.
⁸ Historical Yield represents the arithmetic average of the annual Dividend Yield on the S&P 500 Index over the indicated time period, ending December 2014.
⁹ EWM Estimate for Total Return represents the sum of Nominal GDP, the differential between S&P EPS Growth and Nominal GDP Growth (see note 4), the valuation differential (see note 7), and the current Yield on the S&P 500 Index.
¹⁰ Historical Total Return represents the annualized Total Return on the S&P 500 Index over the indicated time period, ending December 2014.
¹¹ Projected Total Return represents the sum Nominal GDP, the differential between S&P EPS Growth and Nominal GDP Growth (see note 4) and the current Yield on the S&P 500 Index.
Q&A with Orlando Montalvo

Q: German stocks have gone up a lot in the last year and the euro currency has fallen significantly over that time period. What is your outlook for this particular strategy now?

A: We believe the European Central Bank’s unprecedented bond buying program could continue to serve as a boon for European equities while maintaining downward pressure on the euro. As one of the stronger economies in the region, Germany represents an attractive way of accessing the driving force behind Europe’s momentum.

Q: What are the drivers of currency values?

A: Fluctuations in the foreign currency markets and capital flows between countries can be driven by interest rate differentials, and monetary and fiscal policies, as well as supply and demand equilibrium.

Q: What is the case for investing in a currency-hedged ETF?

A: Over long periods of time, the currency impact on international assets may be neutral. Over shorter horizons, however, the currency impact on international assets can be substantial. Investing in overseas assets introduces currency volatility into the portfolio, which can contribute to more volatile overall portfolio returns.

Currency hedging seeks to minimize the effect of currency fluctuations on the domestic value of investments, shielding the investors from changes in currency exchange rates and helping them achieve returns closer to those of the local market. The hedging decision is based on the belief that currency exposure adds volatility risk to a portfolio without the expectation of corresponding return in the long term.

Q: How are the returns of the underlying investment impacted by the currency hedge?

A: By implementing a currency hedge on a particular portfolio, the currency volatility is largely eliminated from the underlying investments. As a result, the investors can earn a return more purely from the underlying investments.

Q: What are the associated risks?

A: There are several risks associated with any currency overlay products. One of the most important to consider is counterparty risk. At BlackRock, we take a proactive approach in managing counterparty risk by keeping the duration of our contracts to one month. Our dedicated risk analytics group continuously evaluates each and every exposure to ensure that we are well-informed and prepared to act as market conditions change.

Q: In which circumstances would it be better to invest directly in a foreign stock market with currency exposure?

A: Investors who have strong convictions on currency direction may find it beneficial to take on such currency exposure.

Q: How does BlackRock’s execution in the currency hedged ETF space differ from that of your competitors?

A: From a passive currency perspective, BlackRock manages all hedges to a specific index; the goal is to eliminate currency exposure to a portfolio while maintaining low transaction costs. We also provide our investors with choices (both hedged and unhedged) to express their own views. BlackRock uses a unique fund-of-fund structure that incorporates an unhedged iShares ETF and a one-month currency forward basket. This structure affords us enhanced liquidity and more efficient trading. By having a hedged and an unhedged fund with the same equity exposure, clients can customize and create an optimal hedge ratio.

For further information on the Evercore Wealth Management Efficient Architecture® approach to asset allocation, please contact Stephanie Hackett at stephanie.hackett@evercore.com.
Selecting & Managing Illiquid Alternatives

By Stephanie Hackett

Editor’s note: Illiquid alternative assets can enhance a client’s portfolio by providing both diversification and potential for risk-adjusted returns in excess of public markets. In many of our clients’ portfolios, we recommend an allocation of 5%-10%-to illiquid alternatives, which can include private equity, real estate and illiquid credit strategies.

Investing in illiquid assets is not for everyone: Assets can be tied up for seven years or more. For qualified investors who have the ability and the appetite to participate in this asset class – manager and fund selection is key. It is critical to fully evaluate the strategy and structure of each fund, the depth of the management team, and its performance history.

In the first installment of a series of discussions on investing in illiquid alternatives, we explore some of the criteria that Evercore Wealth Management uses when evaluating private equity managers.

Private equity investments can provide access to differentiated return streams, as they can invest in fast-growing companies that are not accessible via public markets. Private equity firms also feature investment managers who have specialized industry knowledge that provides them multiple ways to create...
value in the companies that they own throughout economic cycles.

These factors have resulted in private equity outperforming public equities by 3%-5% per annum over the last 40 years. We refer to this outperformance as the “illiquidity premium.” This premium is significantly increased when investing in top-quartile funds.

We believe this outperformance is a reflection of the differences in skill levels among managers. But how do we as investors identify the best managers? One strong indicator can be past performance, as studies have shown that manager performance in illiquid investments tends to be highly persistent, meaning that those skilled managers who have outperformed their peers and the market in the past have a higher likelihood of outperforming again in the future.

While past performance is no guarantee of future results, it can be a strong indication. There are several additional indicators that we use to evaluate managers. Here, we take a look at each of these considerations in manager selection, as well as some of the red flags that indicate to us that a fund should be avoided.

**STRATEGY**

Is the strategy repeatable? Is there potential for consistent, outperformance, or does this strategy only work in specific periods of market cycles? Does the management team have a thoughtful risk management and portfolio construction process? Does the team have a proven ability to add value via operational and strategic measures, or do they simply rely on financial engineering or market timing?

How does the firm find deals – through off-market transactions or auctions? Does the team have a high standard for underwriting and negotiating deals?

Are there actionable plans to drive profitability in various market cycles, including downside protection? Has the team outlined multiple options for a successful exit from each company? It’s important to look for a robust investment process and a strong deal flow.

**THE MANAGEMENT TEAM**

Is the firm comprised of a high-caliber management team? Do the managers have specialized industry knowledge that gives them insight into which companies will outperform? Is the firm actively involved in the management of its portfolio companies? Does the team have a robust network of industry contacts that provide access to deal flow, management talent, and industry best practices?

**Private equity has outperformed public equities by 3%-5% per annum over the last 40 years**

Does the team have a strong understanding of market cycles and industry trends? Do they have the flexibility and insight to deploy capital across strategies, industries or geographies as the investment opportunity set shifts? Have they shown a successful track record of using their insight in the timing of deals (both investment and exit)? Does the team have multiple ways to add value to portfolio companies, beyond financial engineering?

Does the firm provide the appropriate level of transparency of the portfolio? How often do investors have access to speak with the management team? How is the management team incentivized? Do members of the management team have their personal capital invested in the strategy?

**STRUCTURE**

Are the terms and fees of the funds within industry standards? Does the fund’s liquidity match the liquidity of the underlying holdings and investment horizon of the strategy? How is the fund vehicle structured with regard to minimum commitment size, capacity, quality of investor base, etc.?

**Red Flags:** Just as the above indicators are positive attributes we look for in managers, there are several key criteria that we consider to be “red flags” for concern. These include:

- Excessive growth in total assets under management, in average deal size, or in total number of companies held in the portfolio
- Drifting away from the stated investment style of discipline
- Introduction of non-complementary products
- Portfolio managing multiple products/strategies without sufficient support
- Change in investment team or ownership structure
- High professional turnover or neglect of career development
- Poor compliance, operations or organizational procedures
- Underperformance, relative and absolute

A well-executed investment program in illiquid assets can generate strong returns relative to traditional asset classes. New investments should be evaluated in the context of each client’s risk tolerance, liquidity needs, and investment horizon.

Stephanie Hackett is a Managing Director and Portfolio Manager at Evercore Wealth Management. She can be contacted at stephanie.hackett@evercore.com.
Capital flows in China and market reforms in India will continue to drive Asian middle class consumption growth.

The biggest challenge facing China, and by association, the region, is China’s challenging transition from an investment and infrastructure-led economy to a consumer- and services-led economy. Clearly, this will be a difficult journey, as evidenced by the unfortunate government intervention to stem stock market losses in early July. Private and foreign capital now accounts for 68% of fixed investment, however, up from 42% just ten years ago. More private investment, both locally and internationally, is driving more competition, which in turn is creating wage inflation, currently running at about 8% year over year, and helping the Chinese consume more.

More private sector investment is also likely to enhance productivity, in China and in other Asian countries. The Organization for Economic Cooperation and Development, or OECD, expects Asia-Pacific’s portion of consumption to rise to about 60% of global consumption by 2050, from 35% today. India in particular has very favorable demographics and a reform-minded leader that should help drive the growth of the middle class there. GDP growth in India is running at about 7.3% year over year, faster than any other large country.
Asia's culture is changing

Asia is at last becoming innovative. Shenzhen, China’s version of Silicon Valley, is home to new technology companies that have access to cheap components, a skilled workforce and robust local supply chains. The drone manufacturer DJI, for example, is just six years old but already has a dominant position in the global market. We expect to see more of these success stories as Asia shifts to a consumer-led economy.

Transparency is still an issue relative to more developed markets and investors have to remain very skeptical about GDP and other figures coming out of Asia, particularly China. But continued reform, including privatization and the introduction of more foreign capital, will drive greater transparency and accounting discipline, making bad data and potential fraud less of an issue for investors in the future.

Prime Minister Modi, elected last year, has provided new hope in India, the world’s largest and, arguably, messiest democracy. While China’s population is aging, India’s is young, with a workforce ready to take the reins of a burgeoning global manufacturing hub. This transition, from a more agrarian economy to a manufacturing-based one, is not unlike the transition China achieved in recent decades and bodes well for the country’s rapidly growing middle class.

Indonesia also has favorable demographic trends. At around 250 million, its largely urban population ranks fourth in the world and about half of the Indonesian people are under the age of 30.

Valuations remain relatively attractive

China’s Shanghai stock market has taken a dive recently, falling into bear market territory by the end of the second quarter and losing over 30% in just a few weeks. But share valuations for the region are not full relative to the rest of the world. As illustrated in the MSCI chart on the previous page, price to earnings ratios for Asia ex-Japan continue to lag those in the United States and Europe. This suggests to us that there is still some potential for expansion in the Asian markets.

We continue to believe the best investment opportunity in the emerging markets remains in Asia ex-Japan through an active manager who can parse the many risks and identify opportunities. With increasing productivity and wages, a rising culture of innovation, opening of capital flows, reform-minded politicians and reasonable valuations, the region’s dynamic and growing middle class should drive global growth for years to come.

Brian Pollak is a Partner and Portfolio Manager at Evercore Wealth Management. He can be contacted at brian.pollak@evercore.com.

Rising Wages and Productivity Behind Asia’s Rising Share of Consumption

Global middle class consumption (2000–2050)*

Notes: Global middle class consumption is defined here as household consumption between USD 10 and USD 100 Purchasing Power Parity (PPP)/day. Projections hold most recent distribution constant (from PovcalNet database) and assume consumption equals income growth (projected by a Cobb-Douglas production function, a model of Real Exchange Rate (RER) convergence based on the Balassa-Samuelson model, and UN population projections).


*Data represented beyond November 2011 are estimates only.
Global Investment Management

Scott Kamran on Technology Software

Editor’s note: Scott Kamran is a Senior Managing Director in Evercore’s growing technology advisory practice in Menlo Park, California. He joined the firm in 2013 from Bank of America Merrill Lynch, where he was co-head of global software investment banking. He has since worked with leading software, technology, private equity and venture leaders including SingTel, Vista Equity Partners, Insight Venture Partners, Blackbaud, Fleet Complete, and Francisco Partners. Here, he speaks with Independent Thinking about his perspectives on the software business, some potential winners in their sector, and how six years of U.S. Navy experience translates in Silicon Valley.

TECHNOLOGY AND GDP GROWTH

Technology has become detached from the broad economy, as it reaches into every aspect of our lives. As a whole, it should outstrip GDP by about four percentage points, at almost seven percent a year. (See John Apruzzese’s cover article.) Software, which is the largest and fastest growing technology sector – an approximately $400 billion industry worldwide – should grow at about 10% to 12% a year in the United States.

Between 60% and 70% of the value of our cars, for example, is now in the software; soon it will be 90%. Whole industries are being disrupted, especially by Internet digital media companies, and that pace of change is only going to increase. Companies like Splunk and Blackbaud, to pick just two, are changing the way corporations and even nonprofits manage their work and engage with their customers and donors, respectively. Consumers and corporations together spend $1.3 trillion a year on software, not just on the new products that we all know about, but those that make earlier corporate investments in technology run better and quicker.

CONSUMERIZATION

We are just beginning to see developments in software that will enable information technology to work the way it should. Employees need to be able to access their corporate systems from anywhere in the world, from a wide range of devices. Young, well-educated people, who grew up with consumer technology, are used to working that way and have expectations for the same level of access in the workplace. IT departments are going to have to make significant changes to their core infrastructure to adapt to these expectations.

$1.3 trillion
Annual spending on software
CUSTOMIZATION

Ten years ago, only big corporations could really invest in software, paying vendors massive fees and then paying consultants even more to spend a year or so customizing the product, which wouldn’t otherwise work with the company’s other software. Everyone at the company hated the software and hated the vendor. Today, even a small company can almost immediately download software that is specific to its industry and needs very little customization or integration. Software is much cheaper, more flexible and adaptable now, and becoming more so every year.

VIRTUALIZATION

Servers used to do a few things at one time. Through virtualization, in which a virtual, rather than actual, version of a hardware platform, operation system, storage device or computer network resource is created, that server has effectively been divided into 10, 50 and, now, 500 servers, that can accomplish exponentially ever more. That’s not great for the legacy hardware companies, but it is very meaningful for the software companies that support this surge in productivity.

SECURITY

Security is now top of mind for everybody, especially in the corporate sector. There are thousands of data breaches every day, and often the companies and consumers affected don’t even realize that they were exposed until months later. At this juncture, just about everyone in the United States has had his or her credit card information stolen at some point. It’s still early days in combating fraud, but we are starting to see the corporate security budgets being pulled out of the IT departments, as senior management executives consider the increasing risk and potential liabilities. There is great potential here for software companies.

FROM THE U.S. NAVY TO INVESTMENT BANKING

I served in the first Gulf War, in 1990, and my worst day here is never anything like it was there. The Navy taught me how to deal productively with a wide range of personalities and how to work in a team. The investment banking business is hypercompetitive and if we didn’t work as a motivated team, we would lose every time. Evercore has a great team in Menlo Park, and we are really growing the practice.
One way we view consumer spending is by “share of wallet” or how much the average American spends on a category as a percentage of his or her total expenditures. The single largest increase in share of wallet, as illustrated on the next page, has been medical spending. This includes not just personal spending on over-the-counter medication, but also the costs associated with healthcare on behalf of a household, such as employer-paid health insurance and government-financed medical care. While Americans are buying more clothing and eating more food, they are spending less per item on an inflation-adjusted basis, freeing up funds for home and healthcare expenditures.

While the composition of spending has changed, the underlying drivers of retail demand have remained relatively constant for decades. Employment is the most powerful driver of retail demand, as higher employment rates and payroll growth result in increased confidence and discretionary spending. Household asset value is also important, as wealthier people consume more, generally speaking. A measure of taxation on the consumer from the standpoint of higher energy costs or inflation in excess of wage growth also has consistently had an impact on retail demand.

Retail formats continue to evolve in response to meet changes in consumer demand.

E-commerce is now rapidly changing the way that retailers operate their businesses.

Craig Menear, CEO of The Home Depot, recently noted that the current rate of change in the retail sector has probably been greater over the last three years than in the last 50 – and the pace of change is likely to accelerate. The models most likely to succeed over the next decade will be those with barriers to e-commerce penetration, membership models, and the structural characteristics to support the incumbents.

In many categories, e-commerce has created price transparency and won customers away from retailers that only offered physical locations.

Early in its evolution, purchasing goods on the Internet came at the expense of the traditional retailer – generally in categories where the products were commoditized, didn’t need to be touched, or had a high price-to-weight ratio, such as in books, music, and event tickets. As shoppers became more comfortable with online shopping, and perhaps more important, began to trust the online review process, retail capital expenditures became increasingly directed toward building out the e-commerce infrastructure required to compete with online-only retailers. By 2014, most traditional retailers were growing their online sales at a pace equal to the overall growth in total e-commerce spend of 15%, and much higher than the 4% pace of growth experienced in the retail sector as a whole.

Auto parts, paint, and cosmetics retailing are examples of models where the threat of online disintermediation is limited due to the need to see the product or the immediacy of the purchase. If a car is broken down, most people are not
willing to wait days for a replacement, nor are they able to match paint colors online, at least not yet.

Membership models such as Costco are profitable based on membership fee income, rather than the traditional retail model of generating profit on the product. The model provides the customer tremendous value and the retailer tremendous volume. Amazon Prime is another membership model where customers pay $99 a year for free shipping and digital streaming content; we estimate that 40 million U.S. households, about one-third of total households in the country, have signed up for the convenience of this disruptive retail model.

In the home improvement sector, stores such as The Home Depot or Lowe’s offer a breadth of products and an in-store experience that makes it difficult for both online-only retailers and new physical retailers to compete. The bulky nature of many of their goods and the consumer need to purchase a basket of items to complete a project also provide a substantial barrier to entry for online-only retailers and physical retailers alike.

The key to investing in U.S. retail is to understand how shifts in spending will impact growth and free cash-flow generation across the space. Without significant investment in e-commerce, the retail models that worked for the last half-century will not be the retail models that succeed in the future.

*Editor’s note:* Evercore ISI is a leading provider of sell-side research in the United States and one of the range of Evercore Wealth Management research providers. Here, Matt McGinley discusses the outlook for the retail sector.
Technology and the Human Touch

By Iain Silverthorne

Private clients are gaining a great deal from technological innovation. In common with just about every other industry in the United States, technology is transforming wealth management, affording investors greater access to research and investment products, lower transaction costs, and improved reporting.

New tech-based services can also help attract a new generation to investing, just like the discount brokers did for their parents, providing them with online tools to save and access basic automated financial advice. Global investment in financial technology, or FinTech, tripled to $12.1 billion in 2014¹ in part on expectations that tech-savvy young people will naturally want to engage with computers, rather than people. The jury is still out as to whether these firms will survive a market downturn, however.

McKinsey & Co. noted in early June that it is not yet clear whether these firms can move beyond simple investment solutions, capture non-Millennial investors at scale, or replicate the trust and intimacy of a human advisor.² That’s because investing is never just about the money. It’s about articulating lifestyle, family, business and philanthropic goals, adjusting tactics as markets and personal circumstances change, engaging family members, and securing retirements and legacies, through all market cycles.

Consider asset allocation, ideally the product of personalized wealth planning. Robo Advisors, as the new online services providers are commonly called, instead rely on general questionnaires, usually based on algorithms rooted in Modern Portfolio Theory, to establish risk and return objectives. The resulting asset allocation is to mostly passive investment vehicles, not dissimilar to the so-called target date options in 401(k) plans, albeit generally more cost effective.

This is a workable solution, provided the investor has only cash to invest, needs only a basic level of financial planning, truly understands his or her risk tolerance in all market conditions, and doesn’t really want to talk to another person. (It is almost impossible to access actual humans at these firms.)

Their algorithms won’t tell you how much Apple stock to donate or suggest sophisticated gifting strategies, such as utilizing a charitable remainder trust.

Cash flow planning, liability analysis, concentrated stock planning, charitable planning and, of course, multigenerational estate planning, are similarly beyond the capabilities of FinTech. It’s unlikely that any software application could ask the right questions in the first place, let alone consider all the factors required to create a truly customized financial and investment plan.

Technology has made it much easier for clients, particularly those with less complex accounts, to build cost-effective diversified portfolios, which is a good thing. It has also made access to investment information much more readily available and, as such, consumers are armed with a lot more information, particularly about fees. There is no doubt that increased transparency is good for the industry as a whole.

Each individual and family situation is truly unique, however, as are attitudes to risk in different market conditions, especially in a down market. The best advisors – whether coaches, teachers or preachers – are the people who can inspire and guide their charges, in good times and in bad, and at every fork in the road. For now, and probably for years to come, high net worth investors are better served by experienced advisors who are able to really listen and communicate with their clients.

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Investors with concentrated single holdings or existing portfolios comprised of individual stocks, bonds, and mutual funds would have a difficult time transitioning to Robo Advisors, which aren’t able to incorporate existing holdings into a portfolio. Forced sales would likely incur large tax gains.

It’s also important to note that the complexity of income and estate tax law requires careful consideration when implementing investment strategies. Tax loss harvesting is a much-touted capability at several of the new financial technology firms, but none are able to manage the treatment of highly appreciated assets or advise how to incorporate charitable gift planning to mitigate the liability.

$12.1 billion
Invested financial technology
Finding the Balance

By Helena Jonassen

Trust beneficiaries and their trustees face a dilemma. Yields on a balanced trust portfolio, at 2.6% after taxes, fees and inflation, are about half of what they were in the 1970s, arguably lower than their grantors ever envisioned. What is the reasonable distribution that beneficiaries can seek from their trusts?

Determining how much is enough is complicated, for families and their advisors. Trustees must first consider the intent of the grantor but also the needs of the current and future beneficiaries. Is the primary purpose of the trust to provide for a surviving spouse, for the next generation or for the family as a whole, including grandchildren and future generations? Depending on the terms of the trust document, a trustee should be able to determine a sustainable level of distribution without materially harming the interests of subsequent beneficiaries.

In every situation, the trustee under the Prudent Investor Rules, as Evercore Wealth Management Portfolio Manager Jay Springer discussed in the previous edition of Independent Thinking, must diversify assets and strive for the best possible risk-adjusted total return, just as we do for all investment portfolios.

That means careful consideration of the consequences. The top federal capital gains rate of 20% and income tax rate of 39.6%, combined with the Medicare surtax of 3.8%, kicks in at just $12,300 for a trust, compared with $413,200 for an individual taxpayer. State taxes further complicate matters, especially in high-tax jurisdictions such as New York and California. Trustees need to consider whether income should be distributed to the trust beneficiaries to be assessed a lower income tax, and whether this makes sense for the family as a whole and in the context of the purpose of the trust.

Of course, it can work the other way too: Income in excess of need can be retained and added to the principal, and then saved for future beneficiaries in an estate tax-free vehicle.

As illustrated on the following page, the more an income beneficiary takes from the trust, the less is left for the future beneficiaries. Take too much and the value of the trust will deteriorate. However, if the income beneficiary does not have a taxable estate, is at a lower income tax bracket than the trust, and, although this is unusual, is able to accumulate the remittance in an investment portfolio, the family may come out ahead. The tax considerations for trusts can be complex, and families should consider their options in close consultation with their wealth advisors.

Assuming a balanced portfolio allocation, we can expect a trust to grow at approximately 6.1% over time, or 2.6% after taxes, fees and inflation. If the trust
distributes 3% or less, it should reasonably be able to maintain its purchasing power over time. Market values can fluctuate dramatically, however, and beneficiaries can see big swings in their remittances if a fixed percentage of the market value is withdrawn each year. For that reason, trustees should consider a rolling three-year market value of the trust in calculating the fixed dollar remittance, to smooth out the proceeds year over year.

When we serve as our clients’ trustee through Evercore Trust Company, N.A., our first responsibility is to carry out the wishes of the grantor – to exercise our judgment through his or her lens. We take care to counsel beneficiaries that the interests of the subsequent beneficiaries – often their own children – could be impaired by invasions of the trust, and we look to the intent of the grantor of the trust. Each family situation is unique, of course, and there are many cases in which accessing the principal makes sense and is within the intent of the grantor. In those cases, we work with the current beneficiaries and exercise our discretionary authority to make distributions of income and principal.

It’s important to note that some states have adopted an alternative solution, a unitrust conversion. This permits the trustee to pay out a specific percentage of the trust, a sum that is recalculated annually. However, clients are generally better served by trustees who, where allowed, exercise the power to adjust principal to income. These trustees, ourselves included, can accommodate for changes in the prevailing market conditions and the individual needs of the beneficiaries.

It is in the best interests of all the trust beneficiaries, as well as the trustees, to determine an equitable solution for the whole family.

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Setting Priorities in a Low-Return World

By Jeff Maurer

The recent changes in our capital market assumptions, addressed in this issue of Independent Thinking, have a more immediate impact on our Baby Boomer clients than on subsequent generations. For many of us, this is an opportunity to reconsider the relative importance of our long-term goals and ensure that we are taking care of ourselves. All of us want the peace of mind that comes with knowing that we, and our surviving spouses, will not run out of money in our lifetimes. Just how much that takes is a very personal matter – some of us are content with subscriptions to our local opera company; others can’t imagine life now without private air travel – but we generally have a common interest in preserving our lifestyles.

Families can set workable goals, and spend and invest accordingly.
Most of us consider our legacies to be an important but secondary objective. For just about everyone interested in leaving a legacy, almost regardless of the size of the estate, there will be discussions first about the need to preserve adequate assets for spending. Even in this low-growth, low-inflation environment, the expenses associated with living well, including top medical care, private schools for children and grandchildren, and housing in tony zip codes, continue to rise, often at a rate well in excess of inflation.

For many Baby Boomers, including even very affluent members of our generation, a 2.6% net annual spending rate won’t be sufficient to maintain our current lifestyle. Someone in this situation could choose to spend more and, in effect, annuitize their assets. For example, spending 4.5% a year of a $20 million portfolio from the age of 65 would leave $5.15 million at age 100. Spend less and the legacy is greater; spend more and it’s less. (See John Apruzzese’s article on page 2 and my own CEO column on page 1 for the rationale behind this rate of return.)

Current estate tax exemptions, which allow a married couple to leave $10.86 million free of estate tax to their family (or as much as they desire to philanthropic causes), afford families with more than this amount access to estate planning opportunities that can help satisfy both lifestyle and legacy goals. Deciding to irrevocably transfer assets, removing them from an estate and avoiding tax on future appreciation, is one good example. But reduced growth expectations affect all of us; something may have to give, even at the most elevated asset levels.

Competing goals can make for interesting conversations in our offices and at our clients’ homes. Our Thoughtful Giving educational series engages couples first and then their broader families to develop and articulate realistic – and productive – expectations. We often find that each generation is more receptive to communication than the other fears. Just as parents are anxious to leave assets to the benefit of their children, children can be anxious to know that their parents are taking care of themselves.

Once couples and anyone else at the table realizes just what a 2.6% after-tax, after-inflation spending rate will – and won’t – buy, they can set workable goals, and spend and invest accordingly.

Most of our clients review their spending annually with their wealth advisor and adjust accordingly, allocating first to their and their spouses’ living expenses, and then to their family and philanthropic legacies, generally in that order. Again, it’s an individual choice, and some do make very different plans. Either way, it’s important to note that we also encourage all of our clients to set aside savings in years of excess growth to help buttress years of subpar or negative returns, helping them stay on the right course.

Planning in this low-growth environment, especially for Baby Boomers, is a dynamic process that needs to be based on realistic assumptions and effectively communicated. The dividend is peace of mind, which is something that we can all agree is worth the effort.

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Marriage Equality

By Darlene Marchesani

Same-sex couples across the United States are reviewing their estate plans in the wake of the June 26 Supreme Court ruling that legalizes same-sex marriages in all states. Here are some of the issues families should begin considering, in consultation with their wealth advisors, based on their specific circumstances:

- All married couples are now able to take advantage of the unlimited marital deduction and the portability provisions, which allow a surviving spouse, in certain circumstances, to take advantage of the deceased spouse’s unused Applicable Exclusion Amount ($5.43 million in 2015).
- Same-sex spouses are now able to split gifts when making annual exclusion gifts ($14,000 in 2015) to children, relatives or friends.
- Couples may want to consider life insurance options, including purchasing a second-to-die life insurance policy, to provide liquidity to pay estate taxes due upon the death of the surviving spouse. With proper estate planning, there should be no estate tax due on the death of the first spouse.
- Each spouse should review his or her retirement accounts, since a surviving spouse will now be entitled to a rollover of a deceased spouse’s account without being required to take minimum distributions or lump sum distributions. Further, in a 401(k) plan, a participant will now need to obtain his or her spouse’s approval to name someone other than the spouse as the beneficiary.

- Married couples will now be required to file their income tax returns as “married filing jointly” or “married filing separately.” Couples may wish to amend any income, gift or estate tax returns within the statute of limitations period, and obtain a refund of any overpayment. Same-sex couples may still be able to amend tax returns for 2012, 2013 and 2014.

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