Investment Outlook: Navigating a Sea of Debt

Protecting Market Gains Through Diversification

Baby Boomers: Health & Wealth

Investing for Family Trusts

Matthew McAskin on Healthcare Services

Q&A with Blackstone’s Douglas Ostrover

Evercore ISI on Changing Demographics
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 a firm that prides itself on our independent thinking, we are constantly testing our views, against our colleagues in robust meetings, against the research analysts we consult, and against those of the broader market consensus.

The result is often a contrarian take on the markets, contributing to an investment approach that has worked well. We’ve delivered strong performance across our asset classes, as measured by both traditional benchmarks and in meeting or exceeding our clients’ goals, in the context of their individual appetites for risk. Keeping that edge as market conditions change will test both our investment and planning skills. I am confident that our approach, which combines these disciplines, should serve our clients well.

This issue of Independent Thinking includes articles by our CIO, John Apruzzese, and our Chief Wealth Advisory Officer, Chris Zander, which reflect our current views on both the investment and planning counts. They consider strategies to protect the gains of the past six years in a high tax environment, and to diversify ahead of a change in market direction.

In identifying and employing these strategies, we are able to supplement our own core capabilities with nonproprietary investments across the range of asset classes. We seek to identify the best opportunities for each client and then carefully select and monitor those we view as the most capable managers in their field.

One of these investment strategies, the Blackstone Total Alternatives Solution, is featured here, in an interview with the investment committee chairman, Douglas Ostrover. He discusses the merits of what he describes as “patient capital,” and the challenges and opportunities associated with illiquid investments.

We also take a look at healthcare, one of the biggest and most interesting markets in the United States and, arguably, the least understood. Matthew McAskin shares his perspectives as the co-head of the rapidly growing healthcare services practice at Evercore, and I offer my own take, as I do in every issue, from the perspective of an Aging Baby Boomer.

Health is also a factor in establishing certain trusts, as discussed by Jay Springer, a Portfolio Manager, in this issue. We believe that we are one of the few firms with a real focus on special needs trusts, even though they can address some of the issues that most concern families with children who may not be able to fully support themselves.

On a related note, a number of our New York-based clients enjoyed our event on March 9 when bestselling author Steven Brill (America’s Bitter Pill: Money, Politics, Backroom Deals, and the Fight to Fix Our Broken Healthcare System) and CBS News’ Lesley Stahl picked up where their recent conversation on 60 Minutes left off, focusing on the challenges facing the Affordable Care Act and the implications of potential reforms.

We’ve also had some great events recently in our San Francisco, Minneapolis and Florida locations, with plenty more in the works for this spring.

I hope you enjoy this issue and that you find our articles thought provoking. As always, please do not hesitate to contact any one of us at Evercore Wealth Management with any questions or observations you may have, or to learn more about upcoming events. We welcome your views.

Jeff Maurer
Chief Executive Officer
In the six years since governments started taking on increasing amounts of debt to combat deleveraging in the private sector, total global debt has surged by $57 trillion to $199 trillion, outstripping the growth in global GDP. The United States is in relatively good shape, but as investors, we know that we are not immune to trouble elsewhere – or to our own national debt burden, which now equates to 269% of GDP. There is increasing evidence that debt levels of this magnitude suppress economic growth.

New data, as illustrated on page 3, reveals that the much-heralded household deleveraging in the United States since the financial crisis to historically normal levels has been more than offset by government borrowing. The quality of the debt has improved, of course, now that $3 trillion in subprime mortgages that were falsely packaged as triple-A debt have been largely flushed out of the system and the burden has shifted from households to government. Continually combating excess debt with ever more debt is not sustainable, however.

As wealth managers responsible for individual and family assets, it is our job to manage portfolio risk, as well as look for opportunity. While we remain broadly positive on the U.S. economy, as discussed in the previous issue of Independent Thinking, we are also prepared for a range of scenarios that could temper that view, three of which are highlighted here.

The first is that this experiment in quantitative easing, winding up in the United States but continuing in Japan and just starting now in Europe, could end badly, setting the global economy on a course not dissimilar from the one experienced in Japan for more than 20 years. While the United States is reporting improvements in employment and other data, and benefits substantially from low energy prices, the Federal Reserve has not as of writing committed to raising interest rates after six years of holding the Fed Funds rate at close to zero. With rates even lower, effectively negative, in Europe and Japan, central bankers in developed markets have few tools in their toolbox to jump-start their economies if they sputter further or stall.

In emerging markets, where debt has grown at an even faster rate, the outlook is more disturbing. Now at 282%, China’s debt to GDP rate is broadly in line with a number of countries, including the United States, but its rate of debt accumulation, as illustrated on page 4, is much higher, rising 22.8% a year since 2007, and central bank action is failing to stop the economy from decelerating. Still, there are pockets of opportunity, as you would expect in a country with a growth rate of approximately 7%, and we retain exposure to China through the Matthews Pacific Tiger fund, which targets consumer-oriented companies in Asia and avoids large, state-owned enterprises. The fund is also overweight India, one of the very few large economies that does not have excessive debt.

The risk of a stalling or even deflationary global economy is greater than many investors would like to acknowledge, perhaps as high as 25%, in our estimation. Many of the associated portfolio risks seem to us manageable, however. A well-balanced portfolio will have a meaningful allocation to high-quality, intermediate-term bonds,
which will be the asset of choice in a stagnating economy, and allocations to our diversified markets strategy and illiquid alternatives as appropriate for each client (see Brian Pollak’s article on page 5).

Default is another scenario, but one that seems unlikely in the United States, Japan or China, where government debt is denominated in the respective local currency. In Japan and China, that debt is held domestically, which makes this option more unlikely still.

That’s not the case in the Eurozone, where the currency is supranational and the risks and repercussions are still being revealed, most obviously in Greece. It is worth noting, however, that Germany’s export-oriented economy and its relative health within Europe make its equity market appealing. We have recently increased our exposure to Germany through an indexed ETF with a hedging strategy for the Euro exposure, as we expect the Euro to continue to weaken to the benefit of German exports.

We are also keeping our eye on the countries, notably in the emerging markets, that have considerable U.S. dollar-denominated debt. The strength of the dollar could cause a debt crisis if the burden becomes too great.

Global Debt

Since 2007, global debt has increased at a faster pace than world GDP growth, resulting in a higher debt to GDP ratio. Quantitative easing in the United States, Europe and Japan has short-circuited the deleveraging that normally follows a financial crisis. Governments have taken on more of the debt burden.

Source: Haver Analytics; national sources; World economic outlook, IMF; BIS; McKinsey Global Institute analysis.
China’s Debt Level

China’s debt reached 282 percent of GDP in 2014, higher than debt levels in some advanced economies.

Source: MGI Country Debt database; McKinsey Global Institute analysis.
* Numbers may not sum due to rounding.

The third, far more appealing scenario is that the global economy simply grows its way out of this debt burden. After all, the difference between the compounded annual global debt growth rate and that of GDP growth as a whole is just about one percentage point (5.3% and 4.3%, respectively). For this to happen, China would need to steady GDP growth in the 6%-7% area with a shift away from debt and investment; India would need GDP growth to accelerate further; and the United States would need to grow at 3% or more. Together, these events could jump-start Europe. In this scenario, the U.S. stock market would grow in line with company earnings and the valuation gap with other markets would narrow. That growth would be uneven, of course, and would likely reward active investment managers with a fundamental approach in security selection.

These are just three of many possible scenarios, and the fact remains that no one knows how this debt crisis will eventually unwind. The scale is simply unprecedented and there has never been an attempt to return to normal interest rates after zero or negative rates, especially in such leveraged economies. In the interim, we believe that the U.S. stock market is at or near the high end of its historical valuation range after a six-year bull market. We must be vigilant about positioning portfolios so that they are not overweight equities. Markets can remain at high valuation levels for long periods of time, especially when the central bank is being accommodative, but the margin of safety is reduced.

John Apruzzese is the Chief Investment Officer at Evercore Wealth Management. He can be contacted at apruzzese@evercore.com.
Diversified Market Strategies and Illiquid Alternatives

By Brian Pollak

Now may always be the hardest time to invest, but for many investors, this time seems particularly hard across the traditional asset classes. Equity valuations are high, fixed income yields are low and, as discussed in this issue of Independent Thinking, the surge in global debt is suppressing growth. A fundamental approach and a healthy allocation to nontraditional assets allow us to stay fully invested with confidence, even in these circumstances.

The Evercore Wealth Management Diversified Market Strategies, or DMS, asset class is designed to provide stability to investor portfolios when stocks and bonds are struggling. Investments are liquid and generally uncorrelated with both stock and bond markets, but have volatility and return characteristics commensurate with a blended portfolio of stocks and bonds over the course of an investment cycle, typically five to seven years.

The inclusion of uncorrelated assets with an attractive return profile can help reduce volatility for a portfolio as a whole and, in turn, improve the risk-adjusted returns, or the measure of the portfolio return against the amount of risk taken to attain those returns. In other words, DMS exposure can help instill confidence in the broader asset allocation and encourage investors to hold onto more volatile investments, such as equities, during market downturns, sparing them from selling at the wrong time and permanently realizing portfolio losses.

At present, the DMS portfolio is focused on two areas: an absolute return strategy designed to generate a noncorrelated, risk-adjusted return using a basket of hedge fund strategies within a daily liquid mutual fund structure; and a market-neutral long/short equity mutual fund that mimics a very successful hedge fund strategy that has demonstrated low correlation to equity and bond markets and superior risk-adjusted returns since inception in 2009. We have a new offering in our illiquid alternative portfolio as well, in the form of a direct investment that provides a single point of access for eligible investors to gain exposure to a diverse set of illiquid investments from Blackstone, one of the pre-eminent global alternative asset managers. (See the Q&A with Douglas Ostrover on page 14.)

In addition to DMS, illiquid alternative assets are another way to provide diversity in a balanced portfolio, and we have been focused on adding to our investment recommendations in this space. Here, we seek higher returns than our typical growth assets, as we expect to earn a premium of about 5% over and above the relevant index for the illiquidity. These assets are often idiosyncratic in nature and will therefore exhibit lower correlation to the broader market than a typical growth-oriented asset.

We currently recommend that DMS and the illiquid alternatives allocation represent, respectively, 10% and 5% of clients’ balanced accounts. We expect these assets to provide ballast to the portfolio as a whole, if and when it’s needed.

Brian Pollak is a Partner and Portfolio Manager at Evercore Wealth Management. He can be contacted at pollak@evercore.com.
Editor’s note: Matthew McAskin is a Senior Managing Director at Evercore and co-head of the firm’s growing healthcare services business, advising clients on public and private transactions in the hospital, managed care, healthcare information technology, physician services, and outsourced medical services sectors. He joined Evercore in 2013 from Goldman Sachs and has spent the last 20 years focused on the healthcare services sector. Here are extracts from a recent conversation with Independent Thinking.

Emerging Opportunities in Healthcare

By Matthew McAskin

A MASSIVE AND RAPIDLY CHANGING INDUSTRY

Healthcare is a fascinating industry, but one that is also amazingly complex. With the possible exception of education, it is hard to find a sector that elicits such strong personal emotions, and also raises so many social, political, religious and financial issues. Dating back to the introduction of Medicare in the 1960s and, more recently, the continued arguments concerning Obamacare, there are not many topics that seem to garner such passionate attention. As a healthcare research equity analyst once put it, “we are all unwilling participants in this maddening system from the cradle to the grave.”

Some of the themes that we are seeing now in the transformation of the healthcare sector are not new, although the pace of change has increased significantly over the past five years. We are rapidly shifting from a traditional fee-for-service healthcare delivery system to one that focuses on value-based care, lowering costs and improving quality.

A renewed focus on wellness, the rise of consumerism, and re-emerging population health management solutions are all playing a role in forcing many constituents to break down traditional structural and communication barriers to jointly deliver higher quality care. Hospitals, caregivers, payors, corporations, and consumers collectively need to change their mindset, to think about coordinated care management and longer-term outcomes, instead of focusing primarily on the costs of individual tests, surgeries and procedures. This change in philosophy is forcing many of our clients to reconsider sometimes decades-old operating strategies.

THE M&A AND FINANCING MARKET OUTLOOK IN HEALTHCARE

Healthcare is one of the most active sectors for mergers and acquisitions. In addition to healthcare services, the pharmaceutical, biotech and medical device sectors are all experiencing a tremendous amount of strategic activity, as well as capital raising. The management of many public companies has been applauded by investors for using their cash and stock to pursue expansion through M&A, instead of retaining or returning cash to shareholders.

Some of the macro factors driving healthcare utilization and rising costs are well known. Healthcare is an almost $3 trillion industry in the United States, or approximately 18% of our GDP. We have an aging population that will increasingly utilize more healthcare services. Still, healthcare remains highly fragmented and is mostly organized by local delivery systems.
So, it is no surprise to most that new investor dollars continue to flow rapidly into the healthcare services sector. There are various types of organizations prepared to invest anywhere from $1 million to $1 billion or more in individual, privately held companies. Corporate-backed accelerators, traditional venture capital, private equity, family endowment funds, pension funds, and institutional equity funds are all vying to invest in opportunities that range from start-up companies to mature multibillion-dollar healthcare companies.

THE EVERCORE HEALTHCARE SERVICES PRACTICE

We are often asked where and how we spend our time. Traditionally, healthcare services has been a middle-market focused sector, with hundreds of mostly private companies across 20-30 subsectors that traditionally range from $200 million to $3 billion in size. More recently, as our clients have been expanding their service offerings and trying to capitalize on trends, we have seen the smaller and larger ends of this spectrum widen. In other words, clients are seeking earlier stage opportunities, so we need to stay close to emerging growth, digital health and health care information technology businesses, as well as some of our larger corporate relationships asking us to evaluate larger, transformative transactions that may represent a departure from their traditional service offerings.

In addition to our M&A advisory capabilities, many of our corporate and private equity clients turn to us for advice regarding capital market transactions. Evercore ISI gives us a very strong investment research team to join with our existing capital markets platform, which is very important across the healthcare sector. And with the re-emergence of IPOs as a viable alternative for private companies, this has increasingly been an area of focus for many of our clients.

INVESTING IN SCALE

When looking at publicly held companies it is important to note that the top ten companies in the U.S. healthcare services sector comprise about 70% of the overall market capitalization. Traditional sector leaders and bellwethers include United Health Group (UNH), Cardinal Health (CAH) and Hospital Corporation of America (HCA). Instead of resting on their leading market positions, these companies and others have been actively expanding their business offerings to adapt to the rapidly changing landscape and to also position themselves for sustainable long-term growth in multiple areas further away from their traditional core offerings. They have been some of the more notable participants in using strong balance sheets and improving public currencies to aggressively pursue acquisitions as a significant strategic tool.

At the other end of the spectrum, there are smaller-cap companies that may have a more narrow focus on a specific subsector. Examples include healthcare information technology providers, post-acute care (home health/hospice), surgery centers, clinical labs, renal dialysis, and behavioral health companies. These sectors may only have between two and five publicly traded companies each, so they may be more difficult for the individual investor to identify and track, especially as they may not be household names. However, many of these companies represent high-growth opportunities in underserved or less followed sectors.

CHALLENGES FOR INDIVIDUAL INVESTORS IN HEALTHCARE SERVICES

There has been a demand-supply imbalance for public investors, and it can be a challenge to invest in new, innovative models. We estimate that over $300 billion of equity has disappeared from the publicly traded healthcare services market over the past 10 years as a result of public-to-private transactions with private equity, corporate stock buybacks and, most significantly, M&A transactions that were financed in cash. Coupled with a slower IPO market and a very active environment for companies to partner with private equity over the last 10-15 years, there were very few new stories that individual investors could find to invest alongside. Although we have recently seen a renewed interest in IPOs, the potential for a strategic sale or a recapitalization with a private equity partner remain strong competing alternatives.

It is also important to remember that a significant portion of healthcare services companies is comprised of national and regional not-for-profit healthcare services providers. Institutions such as the Cleveland Clinic in Ohio, Kaiser Permanente in California and Aurora Health Care in Wisconsin represent blue-chip organizations that are viewed as innovative integrated delivery models. An individual investor cannot invest in the equity of these organizations, however, given their private or not-for-profit status.

In addition, some of the larger best-in-class private healthcare services companies that may not be household names, such as Multiplan or CHG Healthcare, are majority owned by leading private equity institutions, which may not be accessible to the private investor unless they were to pursue an IPO or join forces with a larger, publicly traded strategic party.

It is truly a remarkable time to participate in this sector. Not only do we all have a vested interest in our personal healthcare decisions, but supporting some of the leading private, public and not-for-profit healthcare companies and caregivers that are trying to transform healthcare can also be incredibly rewarding.
Strategic Wealth Planning

Protecting Market Gains

By Chris Zander

Highly appreciated stocks and higher tax rates are presenting many investors with a high-class problem: what to do with substantially appreciated stock positions. A number of wealth planning strategies can help ease diversification and protect gains, even in these conditions.

The first step is to understand the risks associated with single concentrated holdings (about 10% or more of a portfolio). While there can be reasons to preserve the position (and tax-efficient ways in which to do so), the temptation is all too often to hang on, especially for those with an emotional stake in the company or a fear of paying tax. Indeed, it can take a drop in the share price and corresponding drop in account value, pending retirement or a stock-for-stock takeover to shift an investor’s perspective.

Once that Rubicon is crossed, the diversification needs to be achieved in the most tax-efficient manner possible, in the context of the investor’s lifestyle, family, philanthropic and legacy goals. There is rarely one single strategy that will work on every count, however, and it’s important to consider the full range of options, including potential combinations structured to meet those diverse goals.

Selling the stock outright is the most obvious choice and, prior to 2013, it was often the best, providing a level of certainty. The subsequent rise in federal long-term capital gains tax to 20% from 15% and the introduction of a 3.8% Medicare surtax on high earners resulted in an almost 60% tax increase on the sale of concentrated low-cost stock positions, making this once-simple approach to diversification harder to swallow.

Investors can enhance the value of outright sales and by selling so-called out-of-the-money covered call options, or selling the right to someone else to buy the stock at a specified price from the investor. For stock worth $30 a share, for example, the call option at $33 might be worth $1. By selling another investor the call option at $33, the investor can receive the $1 premium today and, at the time of sale, the $33, assuming the stock reaches that price (and the counterparty exercises the call). If it doesn’t, the investor keeps the $1 premium, which is taxed as a short-term capital gain. The investor continues to have full downside exposure on the stock beyond the $1 premium protection, so it is important to note that this strategy is more of an income enhancement than a hedge.

There are also a number of hedging strategies that can help investors who have short- to medium-term concerns about a stock’s prospects and would like to protect the position while deferring the realization of capital gains taxes.

For pure downside protection, investors can purchase a put option for the right to sell the stock at a particular price. An $85 put option on a $100 stock would protect the holding dollar for dollar should it fall below...
$85. Put options can be prohibitively expensive, however, depending on the volatility of the stock. To offset that cost, an investor could sell at the same premium (subject to market conditions) a corresponding call option at a price higher than the current stock price. This so-called “zero premium equity collar” requires no upfront cash outlay and provides the investor exposure to the stock between the put and the call price, say $125 in this same case, without incurring a full taxable event.

Zero premium equity collars can be attractive hedges. But there are restrictions on the borrowing amounts, and liquidity features have limitations. It’s also important to note that the position itself remains undiversified and any dividends on the stock are taxed at ordinary income rates (and not the lower rates afforded qualified dividends), which adds to the cost of the transaction.

A prepaid variable forward, or PPVF, is similar in structure to an equity collar, in that it has a floor and a cap. In this case, however, the investor agrees to deliver some or all of the underlying shares at a future date in exchange for an upfront cash advance, which does not have to be repaid but is adjusted for the carrying cost. As margin rules do not apply here, the investor may allocate 100% of the cash advance to a portfolio of securities (or other investments). If the stock drops below the floor at maturity, the investor will be required to deliver 100% of the underlying shares (if settled in stock) and the taxable event will occur at that time.

60%

Tax increase on the sale of concentrated, low-cost stock positions since 2013
While the PPVF offers investors the upside in the stock to the cap and defers the realization of capital gains tax to a later date, the opportunity to invest the entire cash advance in securities during the term of the contract is an added benefit over the equity collar.

There are drawbacks, however. The discount in the advance rate is not currently deductible as investment interest expense, and the dividends on the underlying stock are treated as nonqualified, similar to the equity collar. Also, the uncertainty around this transaction if the counterparty uses borrowed shares makes it extremely important to structure this deal carefully, mindful of the often considerable inherent financial, legal and tax complexity involved.

It is important to note that executives deemed to be insiders for SEC reporting purposes must report these hedging transactions, although they are filed differently than an outright sale. Also, many public companies restrict their senior executives from engaging in these transactions under corporate policy. Investors who received shares in conjunction with a public transaction should secure a careful analysis of the regulatory and securities law factors impacting the stock.

As we have discussed in earlier editions of Independent Thinking, philanthropically-minded investors can give long-term appreciated securities to a public charity, donor advised fund or private foundation, achieving immediate diversification and a charitable income tax deduction (subject to limitations), but at the expense of both the principal and income of the assets as well as the flexibility of retaining those assets outright.

A charitable remainder unitrust may be a viable alternative to efficiently diversify a concentrated stock position while continuing to fund personal cash flow and provide a future bequest to charity. This vehicle, which can be established for a term of years or for the donor’s lifetime, allows the donor to contribute long-term appreciated stock, and diversify and reinvest the proceeds immediately without incurring current income tax consequences. The donor receives an upfront charitable income tax deduction, but only on the present value (determined by IRS factors) of the amount that is projected to pass to charity at the end of the term of the trust. During the term of the trust,

**Success is achieved when the advisor and the client are clear about specific goals.**

---

**S&P 500 Total Return Index vs Top Federal Long-Term Cap Gains Rate**

The chart reflects the annual closing index price of the S&P 500 Total Return Index from December 2007 to December 2014 versus the top Federal Long Term Capital Gains Tax Rate including the Medicare Surtax of 3.8% beginning January 1, 2013. The Medicare Tax is part of the Health Care Reform Act passed in 2010. As it applies to individuals, a tax equal to 3.8% will apply to the lesser of:

a. Your net investment income for the year, which includes interest, dividends, and net capital gains (including gain on sale of investment property), or

b. The excess (if any) of your modified adjusted gross income in that taxable year over the threshold amount of $250,000 for married couples filing jointly, $200,000 for single filers and $12,300 for Non-Grantor Trusts

Source: Bloomberg and taxfoundation.org
Entrepreneurs and partners in venture capital funds may be able to reduce or eliminate tax on gains of up to $10 million, if their holding qualifies as a small business stock, or a QSBS under IRC. Sec. 1202.

They must own eligible stock in a qualified corporation for more than five years and meet a series of IRS requirements at the time of issue, including a maximum gross assets test. Additional requirements apply to the general partners of venture capital partnerships, to keep the QSBS status intact.

The capital gains exclusion, which has been modified several times over the past five years, ranges from 50% to 100% of the gain, depending on the date the stock was acquired. State income tax implications must be considered, especially in California where there are additional requirements for QSBS status, as well as a less favorable capital gains exclusion (capped at 50%), and a different alternative minimum tax treatment.

Also worth considering is the option, under IRC. Sec. 1045, to roll over capital gains from the sale of a QSBS held for more than six months, if the individual investor purchases other small business stock during the 60-day period beginning on the date of sale.

These strategies can drive significant savings but require a very careful determination of QSBS status and its impact on other tax planning strategies.

Chris Zander is a Partner at Evercore Wealth Management and the Chief Wealth Advisory Officer. He can be contacted at zander@evercore.com.
China’s economic growth rate is slowing, reflecting the decline in its population of working age. Although much of continental Europe faces a similar demographic headwind, there is the possibility of a stronger cyclical recovery, reflecting still high rates of unemployment in many European countries. Thus far, however, there has been essentially no growth in bank loans. Since bank financing accounts for 80% of total financing for European companies, it is difficult for us to imagine that current signs of more robust economic activity can be sustained. While the United States addressed its banking problem before it began the fiscal stimulus, Europe has yet to do so.

Africa is a wild card in terms of global economic growth. While we are optimistic regarding the prospects for some but not all African countries, it is more realistic to conjecture that their ability to make a significant contribution is not imminent.

The asset class that we are most positive about is U.S. equities: We expect further expansion in the price-to-earnings multiple for the stock market, reflecting “lowflation,” or very low rates of price inflation, low interest rates, and positive demographics.

The usual counterargument to our lowflation forecast is that all of the money printing by central banks in the United States, Europe and Asia will create a global inflation problem. Inflation is a monetary phenomenon – however, our focus is on money demand, as opposed to money supply. In other words, central banks can print money, but they can’t make us spend it. Central banks are increasingly pushing on a string, as evidenced in the continued decline in the velocity of money.

The reality of continued low interest rates poses a significant change in asset choices for investors. When investors are young and working, the focus is on capital growth, which means owning risky assets. As one ages, the focus shifts toward capital preservation and the desire for an income stream. Historically, this meant a shift from equities to fixed income.
While we are not bearish on fixed income, the period of high total returns on fixed income is behind us, and the total returns from fixed income are too low to allow for this major asset shift. This will mean having to own riskier assets longer. The desire for an income stream also means an increasing appeal of stocks that pay dividends.

By virtue of its high birth rate, the United States possesses the most positive demographic profile in the developed world. Demand is firing on all cylinders. Aging baby boomers are shifting their consumption from goods toward experiences. That benefits the financial services and health care sectors, as well as our favorite global industry, international travel. There is an explosion in the number of people who will have the time and the money to travel outside their country of residence.

All developed countries will see a similar shift as populations age. But, unlike most of continental Europe, which faces declining demand for manufactured consumer goods because of a lack of young adults, the maturation of American Millennials is a huge positive for goods consumption. It is also a gigantic positive for housing. A lack of jobs was keeping Millennials from establishing living arrangements separate from their parents. That changed dramatically last year, and the very strong job growth recorded by Millennials is now translating into strong household formations. We are increasingly positive that housing will now begin to make a sustained contribution to U.S. economic growth this year and for many more years to come.

We remain very bullish on real growth in the United States. We expect real GDP growth to average 2.75% per year, comprised of labor force growth of 0.75% and increases in productivity of 2.0% per annum. That translates into a rising real standard of living for Americans.
Q & A with Douglas Ostrover

Q: Blackstone describes allocations to illiquid investments as “patient capital.” Please explain.

A: It can be a long wait to fully invest and an even longer wait to realize returns. In a private market fund investors, also known as limited partners, make an upfront commitment to invest a specific dollar amount into a limited partnership. The general partner, or fund manager, then calls down that commitment over a term of three to six years to fund investments in portfolio companies and to pay fees and expenses. Harvesting investments takes an additional three to six years. Invested capital is returned to the limited partners in the form of distributions generated from company sales or IPOs.

In short, it takes time to achieve the kind of outperformance investors expect; time to identify and source the right deals; time to improve the underlying investment; and time to successfully liquidate the investment, through either the public markets or a sale to a strategic buyer.

Q: Are there advantages in illiquidity itself? How about in inefficient markets?

A: Yes, we believe there are advantages in illiquidity, even in the most efficient of markets. Equity market research shows us that, over the last 40 years, less liquid stocks outperformed those with higher liquidity by almost 3% per annum in large capitalization stocks, and by a greater margin in smaller cap stocks. The study also identified illiquidity as a market factor akin to more historically verifiable ones such as size and investment style.

For nontraditional assets beyond long-only equities, estimates of the illiquidity premium can range even higher. Funds with longer lockups, which enable managers to invest in less liquid holdings, tend to earn higher returns than those without. The data indicates that fund returns actually rise as their lockup period increases, from a median of 4.5% for funds with lockups of less than a quarter up to a median return of almost 13% for funds with a two- to three-year lockup.

While greater illiquidity may increase the inefficiency of a particular market, it does not by itself guarantee higher returns. Instead, it shifts the primary source of the return from the beta, or movements of the market itself, to the individual manager’s skill in managing the investment to a more successful outcome.

Q: Private investors tend to be underallocated to illiquid assets relative to institutions such as pensions or endowments, often for tax reasons. Are there other structural challenges? What role does perception play?

A: Many institutions with long investment horizons and known funding requirements have increased their allocations to illiquid alternatives, to well over 20% on average today. These institutional allocations to private market alternatives far exceed most individual investor allocations, which typically represent less than 5% of their portfolios. The structural realities of illiquid investments create a number of challenges that may constrain the appetite of individual investors for these assets. Three key challenges include...
gaining exposure, achieving a diversified allocation, and maintaining an allocation.

**Gaining Exposure:** Unlike the public markets, where investors can quickly and efficiently increase their allocation by purchasing shares in the open market, private market investors cannot gain instantaneous exposure – time is required to identify private market opportunities and to conduct due diligence negotiations.

**Achieving a Diversified Allocation:** Fund offerings are calendar-dependent, may not be accessible for smaller investors, and often require steep investment minimums. Individual investors seeking broad diversification in the space – across assets, strategies, managers, and “vintage years” – may have difficulty achieving that kind of exposure.

**Maintaining the Allocation:** Making a $1 million commitment to private equity for 10 years is not the same as achieving a constant $1 million allocation for the same period. The average exposure would probably reach about 50% of the total $1 million commitment over that time frame, meaning that only half of the capital is at work for much of the time.

**Q:** How should private investors deploy their own patient capital, across this asset class? What should their expectations be?

**A:** Investors who want to benefit from the performance upside of illiquidity need to be comfortable with the associated process and constraints. Private equity, real estate and distressed debt can be perhaps best understood not as new asset classes but as less liquid versions of existing strategies.

For example, think of an investor’s equity exposure within a “liquidity continuum.” An advisor might position private equity alongside other more liquid equity-like exposures, such as long/short equity, active long-only, and passive equity structures. They are all equity-oriented assets, the longer-term nature of private market vehicles being just one distinguishing characteristic (one that also impacts tax efficiency, as gains tend to be primarily long term, with correspondingly beneficial tax treatment).

The same can be said for allocations to fixed income, which would extend from the most liquid Treasury or bond ETF portfolio, into less liquid high-yield or senior loans, and then long/short credit, mezzanine and distressed debt in the illiquid extreme.

In other words, private market allocations may be best understood as a natural extension of the public or liquid portfolio, with related risk and return characteristics all derived from the overarching asset class that each belongs to.

**Q:** Where does Blackstone see opportunities today?

**A:** Generally, as patient investors, we are able to find investments across all our platforms throughout market cycles. Currently, we see particularly interesting opportunities in real estate, energy, and opportunistic strategies.

In real estate, we think the United States has largely recovered and, as such, our focus has moved to Europe, where overleveraged banks are reworking their balance sheets in light of new regulatory capital requirements, and Asia, which continues to demonstrate strong growth but is lacking the capital to support that growth.

Energy is another rich area for us. We believe that the current dislocation in commodity prices is a result of a temporary supply/demand imbalance as opposed to a secular decline. There will be distressed situations for equity-related investments and others seeking temporary support with rescue financing.

Last, the financial crisis and resulting regulatory reforms have created a lasting impact on the day-to-day operations of money center banks. Global and regional banks continue to assess the services and risks that they are willing to assume in light of the increasing capital requirements. We see attractive opportunities to step into some of voids created by this bank repositioning. In Europe, for instance, we expect to be active in private corporate origination and nonperforming loans.

For further information on the Evercore Wealth Management Efficient Architecture® investment platform and the Blackstone Total Alternatives Solution, please contact Stephanie Hackett at Stephanie.Hackett@Evercore.com.
There is an old saying in this business: You can make a small fortune by handing over a large one to a bank trust department. That was certainly the case for almost 200 years, and some would argue that it remains so, at the expense of the private investor who wants to grow and preserve wealth.

The so-called Prudent Man Rule, later known as the Prudent Person Rule, sounded better than it worked, as capital preservation became the be-all and end-all for fiduciaries. Each investment was judged only on its own merits, rather than in the context of the portfolio as a whole, and risk was avoided at all costs. Fiduciaries managed portfolios first and foremost to avoid lawsuits – and performed poorly as a result.

The shift to the Prudent Investment Rule in 1992 was more dramatic than its name suggests. Since then, a trustee’s investment and management decisions respecting individual assets must be evaluated as part of the whole, rather than in the context of the portfolio as a whole, and risk was avoided at all costs. Fiduciaries managed portfolios first and foremost to avoid lawsuits – and performed poorly as a result.

Change takes time, however. Even long after the adoption of the prudent investor rule, many trust companies differentiate between investing for trusts and for other accounts. To this day, we still hear investors express concerns about establishing a trust, for fear that it will restrict their ability to invest and limit access to their principal.

Most trusts should be invested based on the investor’s goals and objectives, in a manner similar to individual accounts. A properly drafted trust, overseen by the right corporate fiduciary, can be a very powerful tool to protect a family and ensure that an investor’s wishes are carried out. Investment vehicles that were once the preserve of institutional investors can now be used to complement the overall strategy of the trust and to provide specific opportunities to satisfy its risk and return objectives.

For example, consider a trust created for the benefit of a spouse, often referred to as a marital trust. The creator’s primary objective is to provide for his or her surviving spouse in the manner to which he or she was accustomed, even to the extent of exhausting its principal. It is our job as trustee to determine an appropriate asset allocation for the marital trust to meet that goal, for the remainder of the spouse’s life.

A trust created by a grandparent for the benefit of his children and grandchildren that favors the remainder beneficiaries, the grandchildren, by limiting the amount of trust assets available to his children during their lives, serves as a very different case in point. In this example, the trustee must develop an investment objective that balances the interests of all of the respective beneficiaries while satisfying the investor’s wishes.

A special needs trust is particularly challenging (and difficult to establish at many other financial institutions). This type of trust is funded with a finite amount of money that needs to last the entire life of the beneficiaries, who may not be able to work or otherwise care for themselves. Clearly determining an asset allocation and spending rate based on the goal of protecting the beneficiary for life is the trustee’s primary charge. In special needs trusts, the trustee often has to determine the appropriate social and medical treatments for the beneficiary in addition to managing the assets. There are many reasons a family might wish to establish a special needs trust, including cases of addiction and mental illness, and to appoint a skilled corporate trustee to help manage issues that could otherwise impact generations of siblings and children.

There are a few types of trusts that should be considered differently, including a
Jay Springer is a Partner and Portfolio Manager at Evercore Wealth Management. He can be contacted at springer@evercore.com.

charitable remainder unitrust, noted on this page and also in Chris Zander’s article on page 8.

In general, however, a truly prudent investor will manage a trust portfolio as a whole and, as appropriate, to grow wealth as well as to preserve it.

A Word about CRUTs

A charitable remainder unitrust distributes a fixed percentage of the value of its assets revalued annually to a noncharitable beneficiary. The percentage amount must be at least 5% and no more than 50% of the fair market value of the trust. The present value of the remainder, which is the amount expected to go to charity, must be at least 10% of the fair market value of the assets contributed to the CRUT. If the annual payout is reasonably high, the trustee needs to determine the most appropriate asset allocation to satisfy the payout while generating a sufficient return for the charity as the ultimate beneficiary.

At the expiration of a specified time, usually at the death of the settlor, the remainder of the CRUT’s assets are distributed to charity.
Abraham Lincoln observed that folks are usually about as happy as they make their minds up to be. My 40 years of experience in wealth management has taught me just how true that is – and how often it can apply to our physical and financial health.

Advantage is part of it, of course; most of us wouldn’t make it out of the modern equivalent of Lincoln’s log cabin exclusively on our own merits. The Grant Study, now in its 75th year, tracks the lives of 268 Harvard students and, in a related study, compared their experiences with those of 456 other white males of the same age in Boston’s worst neighborhoods. On average, the Harvard men stayed alive and free of disability about 10 years longer than their less advantaged generational peers. (President John F. Kennedy, one of the original subjects, was an unfortunate exception.)

In what appears to be a virtuous circle, happiness can also bring us financial and physical advantage. The students who experienced what the Grant Study describes as warm relationships significantly outearned their classmates, by an average of $141,000 a year in their peak earning years. Those who took care of themselves, notably avoiding excessive drinking and smoking, had far, far lower rates of divorce, neurosis, depression, ill health and death.

Of course, the reverse can also be the case. Significant wealth can bring its own complications, especially in relationships, which can in turn adversely impact our emotional and physical health. I’ve seen arguments between siblings, often caused by the parents who treated them differently, spin out of control, and I’ve seen countless situations in which children would have been better off inheriting wealth later or not at all.

As Paul Sullivan notes in his insightful new book, The Thin Green Line: The Money Secrets of the Super Wealthy, the best intentions of parents can often go awry. One area of perpetual concern is entitlement, which he rightly points out can affect someone whether they think they’re inheriting $30,000 or $30 million. It’s never about the money; it’s about the expectation, often ill founded. The children who turn out the best are the ones whose parents make that connection between their labor and the money it produces. I should note that our Thoughtful Giving educational series at Evercore Wealth Management addresses this topic.
For my part, I like to think of myself as a slightly more experienced version of the lad who played high school and Division III college football. The fact that it’s been ten years since my bilateral knee replacement gives me something to talk about at the event to mark another anniversary this year – my 50th high school reunion. Aging and its consequences are simply part of life, and it’s our job to help our clients and their families prepare, as outlined in the insurance checklist (to the right).

I would add a few suggestions that I feel particularly strongly about: Find a good internist who, even if he or she doesn’t accept insurance, has the time to talk to you and to really supervise your care, with a focus on prevention; be informed about your own health and keep your own records; stay creative and keep learning, both in work and in retirement; contribute your time, energy and money to causes you believe in; and don’t take on more financial risk than you are comfortable with – we know, as the internists of our clients’ wealth, that the associated stress will almost certainly affect your health. Above all, invest in your relationships. Like the men in the Harvard study, I am sure that I have benefited more from my close family and friends than from any other advantage in my life.

As a generation, we are living longer lives than our parents and grandparents did (and in far easier times than Lincoln). We owe it to ourselves – and to our children and grandchildren - to make these extra years as healthy and as happy as we can.

Jeff Maurer is the CEO of Evercore Wealth Management. He writes regularly on the opportunities and challenges facing Baby Boomers. He can be contacted at maurer@evercore.com.

Jeff Maurer

Insurance Primer

By Kate Mulvany

Health Insurance

Working/Wealth Accumulation Years

Everyone needs medical insurance. Group coverage is afforded to most individuals working for companies with more than 20 employees. Where group coverage is not an option, individuals can purchase individual coverage. The Affordable Care Act ("ACA") allows individuals and families to purchase insurance, regardless of pre-existing conditions. Supplemental insurance is available to augment medical insurance for catastrophic risks. Dependents, including adult children, also should be insured.

Transitions

Early retirement, job loss, divorce, or the death of a spouse may cause an individual to lose access to group coverage. COBRA is a federal law that provides for the temporary extension of group coverage at the individual’s own expense. Once temporary benefits are exhausted, individuals can purchase individual coverage through federal or state exchanges, regardless of pre-existing conditions and outside the normal enrollment period. Retirement at or after age 65 qualifies most individuals for Medicare. Those receiving Social Security at age 65 are automatically enrolled in Medicare Parts A (hospital insurance) and B (medical insurance). Parts A & B exclude prescription drugs, so supplemental coverages should be obtained. Medicare enrollment rules are complex, and it is important to understand the associated enrollment periods and coverage options. Retirees with access to continued coverage and those opting to remain in the workplace beyond Medicare qualification age should take special precaution in both the enrollment process and the coordination of benefits.

Disability Insurance

Working/Wealth Accumulation Years

Most individuals in their earning years consider life insurance to be a critical component of their financial plan. The odds are greater, however, that they will instead suffer from a long-term disability. Many employers provide disability insurance when an insured is unable to work. This product usually replaces anywhere from 45% to 65% of gross income. Supplemental plans are available and should be considered.

Long-term Care Insurance

Working/Wealth Accumulation Years

Approximately 70% of individuals 65 or older will need some type of long-term care, according to the U.S. Department of Health and Human Services. Health insurance and Medicare do not cover long-term care expenses, including skilled nursing and help with daily living. Unfortunately, long-term care policies have become more expensive, and many affluent individuals now choose to self-insure. Relatively new and interesting products that combine hybrid life insurance and long-term care policies are interesting, however. These policies allow the insured to essentially receive advance payment of death benefit if needed for long-term care expenses. There are many factors to consider before purchasing coverage, including daily benefit, inflation riders, spousal discounts, lifetime limits, and waiting periods.

Kate Mulvany

Kate Mulvany is a Managing Director and Wealth Advisor at Evercore Wealth Management. She can be contacted at mulvany@evercore.com.
Women Creating Wealth

By Judy Moses

Working women are an economic force that the investment industry is only beginning to recognize, even though the number of American women with incomes in the six figures – or more – is growing at more than three times the rate for men, according to the U.S. Census Bureau. Almost a quarter of married women with children now outearn their husbands and more than nine million own their own businesses.

As a group, women are responsible for $5.1 trillion in personal investable assets, or 39% of the national total, and have decision-making power over twice that amount. Still, fewer than half of these women work with a financial advisor. There are probably quite a few reasons for that low representation, a number of which are the fault of the industry itself. One possibility does seem to stand out, however. Women may be avoiding the subject, at their own expense.

Women tend to rate themselves lower in financial literacy when, in reality, their ability and knowledge is similar to that of men. While women now earn 57% of bachelor’s degrees, 60% of master’s degrees and 51% of doctorates, as measured by the U.S. Department of Education, they do not gravitate in equal proportion to math-related fields, a reflection, perhaps, of that distorted perception of their abilities.

The opportunity cost of avoiding professional financial advice and portfolio management can be significant. Women without advisors, according to the Boston Consulting Group, typically allocate 20% of their assets to cash, or more than double the proportion of those who engage advisors.

A portfolio of, say, $10 million, invested 9% in cash, with the remainder split between equities and bonds, grew to $14.2 million over the past five years. A portfolio with a 20% cash allocation earned $563,000 less. For many women, that difference could represent significant choices in lifestyle, career, or the opportunity to help advance important causes. Past performance is, of course, no guide to the future, but it is worth noting that cash, as an asset class, has underperformed bonds by 4.22% and equities by 11.34% over the past five years.

In short, in trying to avoid risk, many women actually take on risk; the risk of not meeting their financial goals. A clear understanding of the risk-return profiles of different investments in the context of those goals enables all investors – male and female – to stick with an investment plan over time and not be distracted by short-term fluctuations in the market.

At Evercore Wealth Management, we encourage women to fully engage in discussions about their individual and family finances; to learn not just how to create wealth, but also how to allocate and invest their assets to meet their goals. Our Wise Women series of educational seminars helps our clients improve their financial and investment acumen in a like-minded community of women.

Judy Moses is a Partner and Portfolio Manager at Evercore Wealth Management in San Francisco. She can be contacted at moses@evercore.com.
Evercore Wealth Management, LLC is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. This material was prepared for informational purposes only and should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. It does not constitute an offer to sell or a solicitation of an offer to buy any particular security, nor does it constitute a recommendation to buy, sell or hold such security. Specific needs of a client must be reviewed and assessed before determining the proper allocation for a client and must be adjusted to market circumstances. The securities discussed herein were holdings during the quarter. They will not always be the highest performing securities in the portfolio, but rather will have some characteristic of significance relevant to the article (e.g., reported news or event, a new contract, acquisition/divestiture, financing/refinancing, revenue or earnings, changes to management, change in relative valuation, plant strike, product recall, court ruling, etc.). They do not represent all of the securities purchased, sold, or recommended, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. Past performance does not indicate future results. Evercore Wealth Management is compensated for the investment advisory services it provides, generally based on a percentage of assets under management. In addition to the investment management fees charged, clients may be responsible for additional expenses, such as brokerage fees, custody fees, and fees and expenses charged by third-party mutual funds, pooled investment vehicles, and third-party managers that may be recommended to clients. For more information on advisory fees, please refer to Evercore Wealth Management's Part 2 of Form ADV, which is available upon request. The information here was obtained from multiple sources believed to be reliable as of the date of publication, but we make no representations as to the accuracy or completeness of such third-party information and have no obligation to update, modify or amend this information or to otherwise notify a reader thereof in the event that any such information becomes outdated, inaccurate or incomplete. Any opinions herein reflect our judgment at this date and are subject to change. This material does not purport to be a complete description of our investment services. Upon request, we will furnish a list of all securities recommended to clients during the past year. It is not our intention to state or imply in any manner that past results are an indication of future performance, which may vary. Future results cannot be guaranteed and a loss of principal may occur. Trust, estate and custodial services are provided by Evercore Trust Company, N.A., an affiliate of Evercore Wealth Management. The performance results of the Evercore Wealth Management Core Equity Strategy are based upon the returns of a single, fully discretionary account with no material investment restrictions and are reported net of fees, reflecting the deduction of transaction costs as well as a 1.00% advisory fee and assumes the reinvestment of all dividends and capital gains. The account has been invested in Evercore Wealth Management’s core equity strategy since its inception (2/3/2009). Evercore Wealth Management manages its client portfolios according to each client’s specific investment needs and circumstances. Performance results for individual accounts may vary due to the timing of investments, additions/withdrawals, length of relationship, and size of positions, among other reasons. The S&P 500 is the core equity strategy’s benchmark. You cannot invest directly in the S&P 500 index. The S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity, and industry. Unlike the S&P 500, EWM may invest in both US and non-US equities and ETFs. Index results assume the reinvestment of all dividends and capital gains and do not reflect the impact of transaction costs or management fees. In addition, the representative account’s holdings will differ from the securities that comprise the index.

IRS Circular 230 Disclosure:
Pursuant to IRS Regulations, we inform you that any U.S. Federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding IRS imposed penalties.