



INDEPENDENT
THINKING

THE NEW STANDARD IN WEALTH MANAGEMENT

EVERCORE
Volume 47

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THE NEW STANDARD IN WEALTH MANAGEMENT

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A Message from the CEO



“When you come to a fork in the road,” said Yogi Berra, “take it”. The baseball great was apparently giving directions to a friend at the time, but the line is remembered because it hints at an important truth. A failure to make a decision – to take a fork in the road – is itself a decision, and often not a good one.

To my mind, good wealth management is about making continuous judgments, as market conditions and personal circumstances evolve. Consider the topics addressed in this issue of *Independent Thinking*: A changing investment climate, evolving family dynamics, the transition of a business through a sale or succession – all forks in the road.

As of writing, dramatic events are unfolding in the U.S. banking system, with the collapse of Silicon Valley Bank. We’ve communicated our initial thoughts to clients and will be addressing the investment implications as events develop. In the interim, it’s worth repeating that assets custodied at Evercore Trust Company, N.A. are protected as they are not deposit accounts and would not be subject to our creditors’ claims in the event of a bank failure.

As long-term and tax-focused investors, we rarely take dramatic turns in our asset allocation. Instead, we make tactical changes to our core strategic asset allocation, tailored to our clients’ personal portfolio objectives. At present, as our Chief Investment Officer John Apruzzese writes in these pages, that means rebalancing our portfolios to add to our international exposure, while remaining moderately overweight U.S. large cap equities. We are also increasing

our allocation to credit, which we see as an appealing asset class in this higher interest-rate environment. See the article by Partner and Portfolio Manager Brian Pollak for an overview of this asset class, and the interview with one of our long-term managers, David Golub, for a perspective on middle market lending.

Family dynamics also tend to evolve over time, and wealth plans should be revisited accordingly. Kate Mulvany, a Partner and Wealth and Fiduciary Advisor, tackles one of the biggest challenges in wealth management for many families—distinguishing fair from equal in planning for the next generation. Family sprinkling trusts, also known as pot trusts, which assign funds to a class of people, such as a spouse and children, rather than to an individual, can provide a flexible alternative for families in transition.

For business owners, the path to a sale is often a long one, representing decades of hard work. Unfortunately, many owners are so focused on the transition and on running the business in the interim that they can miss an important play, failing to maximize what can be a once-in-a-lifetime opportunity to meet their financial and legacy goals. In our experience, personal financial and tax planning should be considered as early as possible in advance of a transaction, in collaboration with a team

of advisors, including and perhaps led by a strategic wealth planning advisor. As Justin Miller, a Partner in our firm and our National Director of Wealth Planning, puts it here, Don’t leave money on the table!

Similarly, succession planning – whether for a family, a business, or a philanthropic endeavor – takes careful planning. Our Chairman, Jeff Maurer, recalls his own experiences in his regular column, and offers suggestions for structuring a successful succession.

I hope this issue of *Independent Thinking* provides some food for thought as you approach forks in your own personal and professional journey. Please let us know if you have any questions or comments, or would like to discuss these or any other topics. And look for invitations to our events, both webinars and small in-person gatherings.

Thank you for your engagement. We look forward to seeing you soon.

A handwritten signature in dark blue ink, appearing to read 'Chris'.

Chris Zander
President & Chief Executive Officer

The Beauty of Investment Diversification

By John Apruzzese

For almost 13 years, the very best investment returns came from some of the best-known components of the easiest-to-invest-in asset class. From the beginning of 2009 to the end of 2021, the larger the allocation to four companies – Alphabet/Google, Apple, Amazon, and Microsoft – generally, the better the returns.

These household names dominated what became known as the mega caps, the three dozen or so companies valued at more than \$200 billion, most based in the United States. Together, the four accounted for more than 20% of the S&P 500, with annual profit margins of around 18% for the MegaCap-8, or 1.5 times the S&P 500 average and two times the MSCI World Large Cap average, as illustrated by the charts on page 3 and 4. They were, as we wrote a year ago in *Independent Thinking*, among the most successful companies in the 200-year history of limited liability corporations.¹

That era ended a year ago, on March 16, 2022, when the Federal Reserve started reversing monetary policy to combat rapidly accelerating inflation. The S&P 500 index fell 25% between January 3, 2022, and October 12, 2022, and the mega caps fell harder still. One reason was that the big companies had much higher valuations than the broader market at the peak, and

higher interest rates devalued investors' perceptions of future growth.

Today, the valuation gap between these companies and the rest of the market looks likely to continue to narrow, as their growth rates decline from the technology spending boost caused by the pandemic and the extraordinary success of cloud computing – and as governments around the world attempt to rein in their near monopolistic power.

Although we continue to believe that the power, resilience, and business models of many of the biggest U.S. technology companies will lead to strong future returns, we do not expect a return to the recent level of U.S. mega cap dominance. Instead, it seems to us that the better diversified a portfolio, generally, the better the

likely future returns. We are trimming our exposures to the mega caps that have served our clients so well in favor of three asset classes: international equities, credit, and illiquid assets. Let's take a brief look at each.

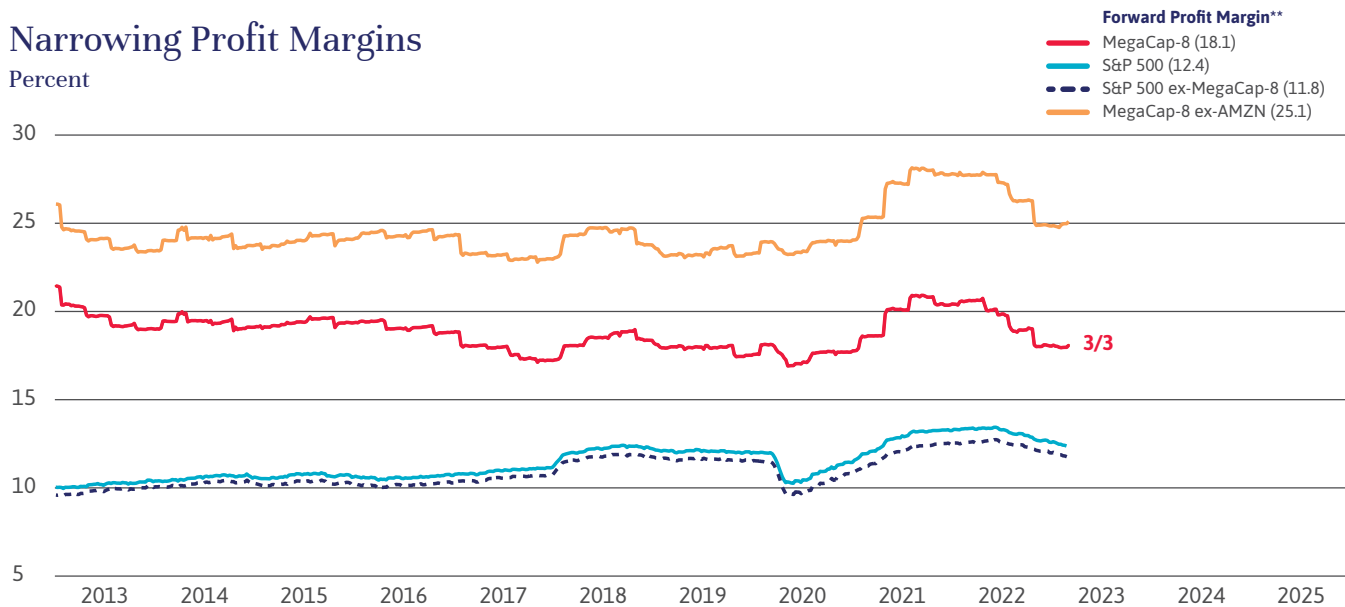
International (excluding U.S.) equity markets, which significantly underperformed U.S. stocks over the previous era, have reached historically low valuation levels in absolute as well as relative terms. A warm winter in Europe has helped the region avoid a major energy crisis and bought European Union countries time to wean themselves off Russian natural gas. And a faster-than-expected reopening in China has offset the economic impact of the country's three-year zero-COVID policy. At the same time, the U.S. dollar is well off the highs of last year, which takes the

¹ <https://www.evercorewealthandtrust.com/powering-technology-continues-drive-markets/>

The better diversified a portfolio, generally, the better the likely future returns

Narrowing Profit Margins

Percent



*MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.
**Aggregate forward consensus expected operating earnings as a percentage of aggregate forward consensus expected revenues.
Source: I/B/E/S data by Refinitiv. Data is through 3/03/23.

pressure off most emerging markets that borrow in dollars. We recommend allocations to equities in developed international and emerging markets, but still at a weight far below the approximately 40% exposure in the MSCI All-Country World Index. Due to the long-term underperformance in international stocks, in many cases we are actively rebalancing international weightings back toward policy, which is approximately 15% of equity portfolios.

Interest rates have moved up dramatically across the major fixed income markets since the Federal Reserve started increasing rates last March, and they are beginning to show attractive real rates based on consensus long-term inflation expectations of about 2.7%. The article by Brian Pollak on page 5 and the interview with David Golub of Golub Capital on page 10 explore opportunities becoming available in the credit markets. For balanced portfolios, we currently

recommend a portfolio allocation of between 5% and 10% to liquid public and illiquid private credit.

Of course, we cannot assume that inflation is reverting to 2% in a straight line; it will be important to orient part of the portfolios to investments that should do well in an elevated inflation environment. We have moved our core equity portfolio weighting to commodity producers, significantly higher, and on the fixed income side we are looking for opportunities to enter positions in inflation-protected bonds, to complement our exposures to Treasuries and municipal bonds.

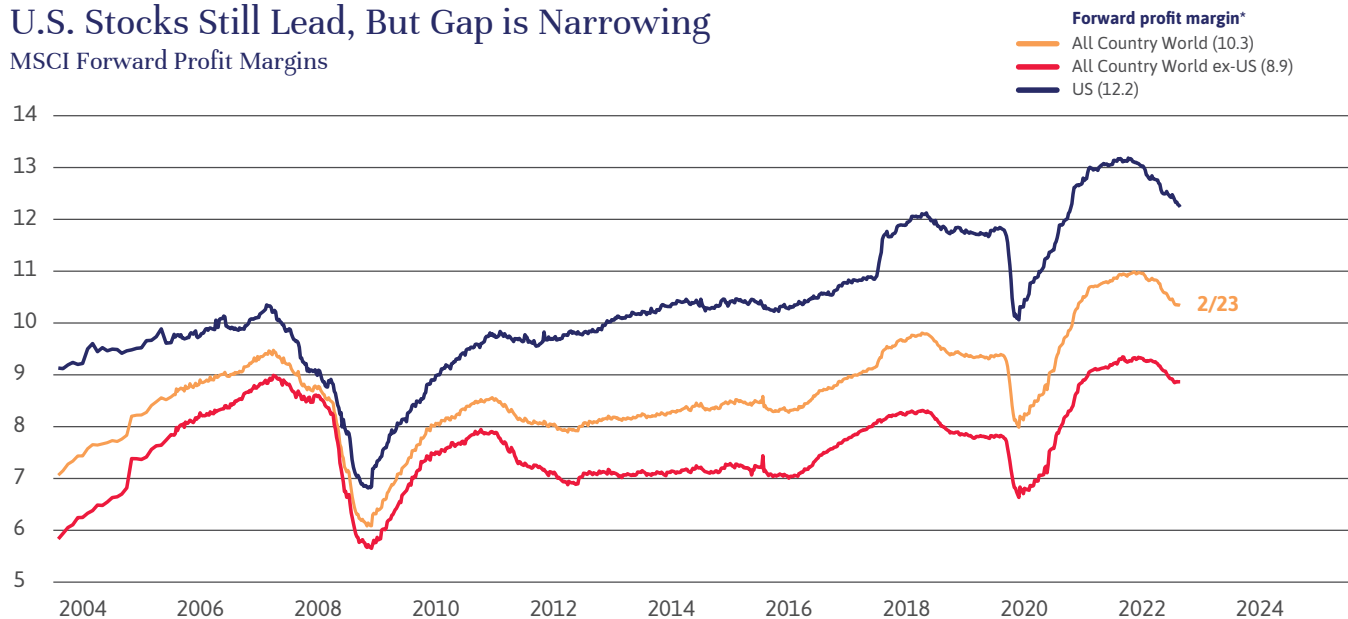
We also continue to search for additional opportunities within the private equity, venture capital, private debt and real estate markets within balanced portfolios that can bear illiquidity risk, including diversified private real estate, private equity secondaries funds, and distressed or special situations debt funds.

In the interim, where appropriate, we will continue to take gains, if available, from the big-cap tech stocks as tax efficiently as possible and to rebalance portfolios. The era we are entering should present many investment opportunities, as well as many risks. We believe thorough diversification is the best strategy to deal with the rapid changes, risks and opportunities that investors currently face.

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

U.S. Stocks Still Lead, But Gap is Narrowing

MSCI Forward Profit Margins



*Time-weighted average of the consensus estimates for current and next year. Monthly through December 2005, weekly thereafter. Source: I/B/E/S data by Refinitiv. Data is through 2/23/23.

A Credit History, Built on Trust and Innovation

By Brian Pollak

Since ancient Mesopotamian farmers borrowed seeds with the promise to share their crop to pay off their debts, credit has supported economic growth. Trust, which is the Latin meaning of the root word cred, is the foundation of lending. The greater that conviction, the better the terms for the borrower. But, as we've come to appreciate through the centuries, the greater the risk, the greater the potential investment return for the lender.

Global credit markets now represent approximately \$40 trillion in capital, spanning corporations, municipalities, real estate, autos, and unsecured consumer credit, across both liquid markets and private, illiquid markets.¹ While we invest the defensive portion of balanced portfolios predominantly in high-quality, investment grade municipal, corporate and Treasury securities (as these securities tend to rise when the economy and equity prices are weak), this higher interest rate environment provides additional opportunities in credit-sensitive investments.

The best-known credit sector is probably the **corporate bond market**, which got going when the Dutch East

India Company borrowed money to finance trade routes in the 1600s. It grew over the subsequent centuries, focused on lending money at low yields primarily to the largest, best capitalized companies, with the strongest balance sheets and lowest risk of default.

This market took on a whole new life in the mid-1980s when investment banker Michael Milken of Drexel Burnham Lambert helped finance companies issuing what became known as "junk bonds" or high-yield bonds. These were bonds issued by companies considered by the market to be risky, usually due to a highly leveraged balance sheet or an uncertain business model. Suddenly, lending to low credit-quality companies at high yields took off, not

just financing private equity leveraged buyouts, or LBOs (Milken's specialty), but allowing corporations of all sizes and shapes access to relatively inexpensive and available financing.

While the trajectory has not been a straight line, facing various difficulties in the savings and loan crisis of the late 1980s and, later, the Great Financial Crisis, the high-yield bond market continued to democratize the credit markets, providing capital to more and more issuers. While Milken himself is a controversial figure, most economists agree that the advent of more accessible capital to higher risk corporate borrowers has been a tremendous boon for economic growth and innovation over the last four decades. Amazon, Netflix, and Tesla are just some of the companies that

¹ International Capital Market Association, Bloomberg

were able to access capital at challenging moments in their respective histories.

Today, the global liquid corporate high-yield bond and loan market includes 2,000 issuers and represents over \$3 trillion in market capitalization.²

The **securitized bond market** rivals the size of the corporate bond market globally. Securitization is the process of taking certain types of assets, typically loans, and pooling those loans so they may be repackaged as marketable securities, in which the interest and principal payments are passed through to the purchaser of the new security. While investment history buffs can trace its origins to farm railroad mortgage bonds from the 1860s, the modern era of securitization began in the early 1970s. That's when government agencies, starting with Federal National Mortgage Association, better known as Fannie Mae, began issuing residential mortgage-backed securities, allowing capital to flow to where it was previously lacking, including low-cost or affordable housing. The Tax Reform Act of 1986 further empowered issuers with greater flexibility to structure bonds with varying maturity and risk profiles.

Private credit markets have grown exponentially

The securitized markets then expanded to assets far beyond residential mortgages, including mortgages secured by commercial real estate properties and automobiles, and various unsecured consumer credit, including student loans and credit cards. Immense growth came at the expense of quality underwriting, however, and the securitized market came to a grinding halt in 2007. But underwriting and lending standards have since improved significantly, and



\$3 TRILLION

the global high-yield bond and loan markets

the industry is now on solid footing, and continues to provide more and more avenues for small businesses and consumers to access debt capital.

Private credit markets, which contain loans that are either smaller or more complex than those available in public markets, have also grown exponentially since the financial crisis. Private lenders today provide capital to the over 15,000 small or middle market companies that are not traded publicly.³ Global private debt has a total market capitalization of over \$1.4 trillion, up from \$250 billion in 2010, as illustrated by the chart below. This rapid growth in private lending has provided capital to an increasingly diverse set of companies, by expanding access beyond local

² JP Morgan, Bank of America, 03/01/2023
³ World Economic Forum

It will be interesting to see how credit lending continues to evolve

bank lending offices to the often more robust and creative private capital market lenders, helping the companies to grow, hire, and combine. Please see the interview with David Golub, one of our longtime external managers, focused on middle market lending, on page 10.

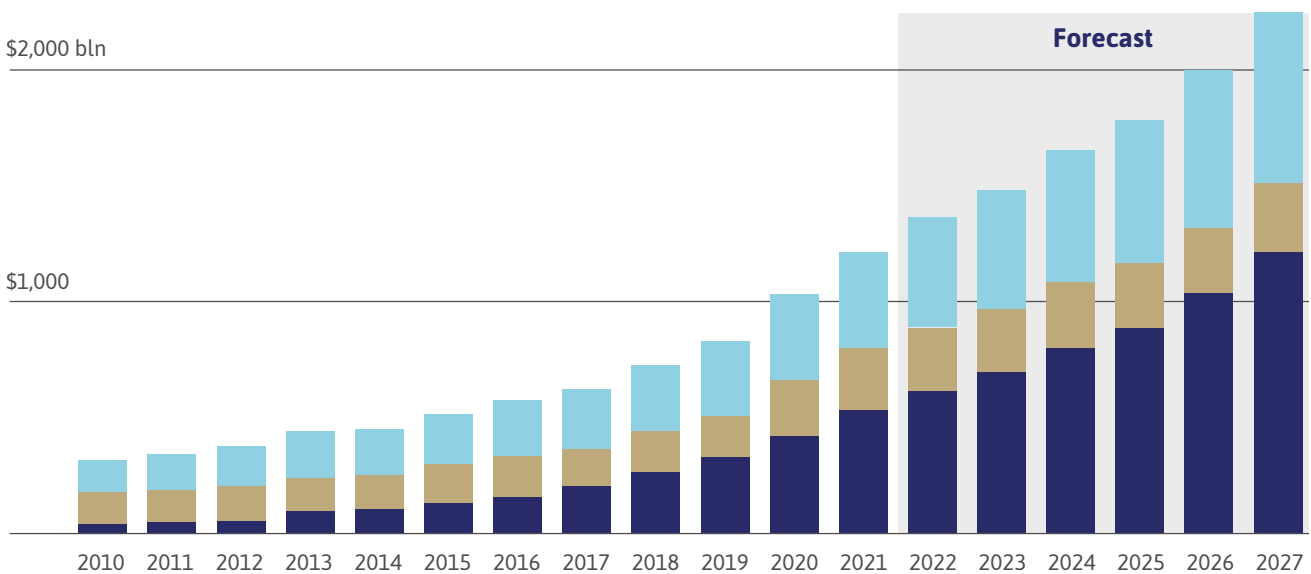
We’ve come a long way from seed-based loans (although it’s interesting to note that credit still underpins the global food supply). The credit market, both private and public, has weaved its way into once idiosyncratic areas, creating risk-adjusted opportunities that the Dutch East India Company and Mesopotamian lenders might have marveled at – including in

high-yield corporate bonds, securitized bonds, and various investments in private credit. All of these look more appealing now after a brutal 2022, in which most credit-sensitive investments saw prices fall and yields increase – for instance, the Barclay’s U.S. Corporate High Yield Index fell by over 11%, and yields increased to over 8% from just over 4%. It will be interesting to see how credit lending continues to evolve. At present, diversified credit investments with appealing risk-adjusted return profiles, in the public markets and, where appropriate, private markets, seem to us a reasonable component of our fixed income portfolio asset allocation, in addition to Treasuries, and corporate and municipal bonds.

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

The Rapid Rise of Private Lending

Global Private Debt Assets Under Management by Sub-Strategy



Source: Prequin

Investing in U.S. Mass Transit Systems

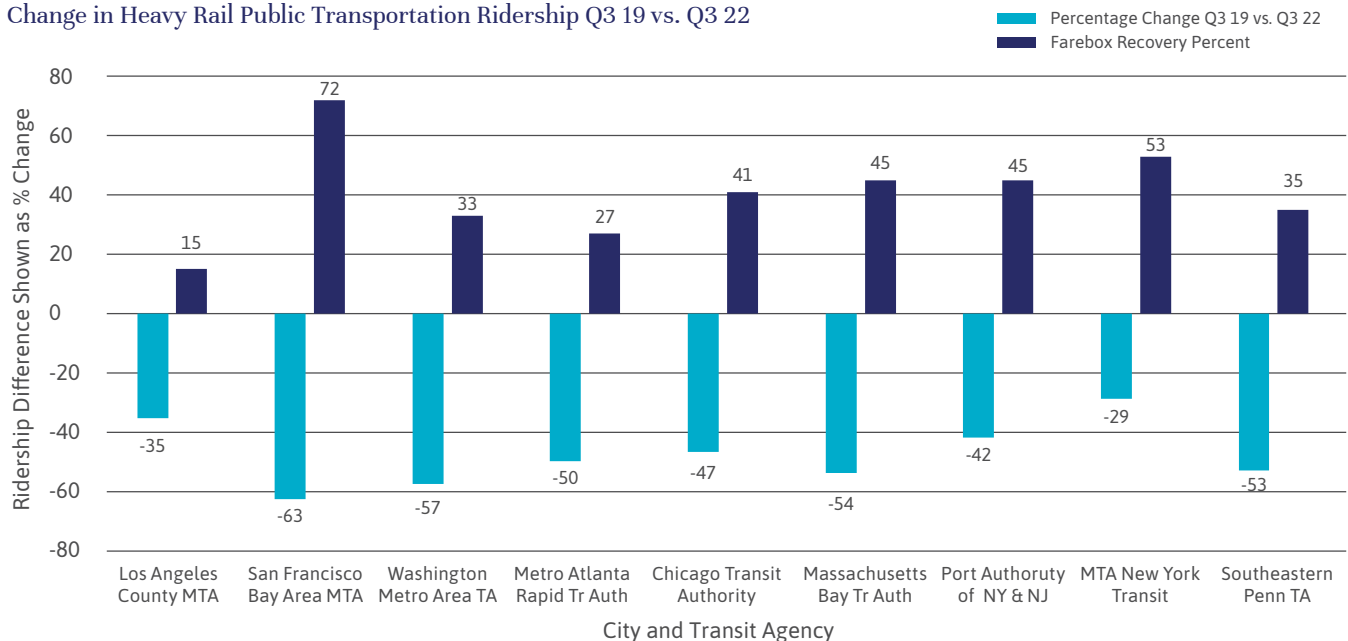
By Howard Cure

Ridership on mass transit systems in the United States has not fully recovered from the pandemic – and there’s a good chance it may never, as many white-collar workers now work at least partially from home.

Editor's note: This is an extract from the recent Evercore Wealth Management publication, “Mass Transit Systems: Lawmakers all Aboard (For Now).” To view the paper in full, please visit our [website](#) or contact your Evercore Wealth Management advisor.

Mass Transit Ridership Trends

Change in Heavy Rail Public Transportation Ridership Q3 19 vs. Q3 22



Time-weighted average of the consensus estimates for current and next year. Monthly through December 2005, weekly thereafter.
Source: American Public Transportation Association, ENO Center for Mass Transportation

Fewer riders overall mean lower fare revenues, potentially making transit more unaffordable for the many blue-collar workers who need to commute and may struggle with large fare increases. Attracting white-collar riders back to mass transit systems requires improvements in safety, cleanliness, and timeliness, all of which will increase the systems' costs. Indeed, many systems will require changes in service, fares, and operating and capital plans to provide adequate service. Other challenges to these systems include the potential halt to the significant federal aid that was used to stem revenue losses during the pandemic, uncertain inflation-related wage pressures, and uncertain dedicated tax revenues, which are used to subsidize operations.

Mass transit systems will continue to receive support

Mass transit systems are capital intensive, and many have a significant amount of debt outstanding, with a variety of security pledges. For example, the Metropolitan Transportation Authority of New York, or MTA, has \$47.1 billion in outstanding debt. That equates to 1.2% of the entire \$4.04

There is considerable opportunity in this sector for bond holders

trillion municipal debt market, which has over 36,000 issuers. But mass transit bonds are generally creditworthy, given the critical importance of the systems to the regional economies. We expect that mass transit systems will continue to receive broad political and financial support from parent governments in identifying and implementing solutions to their operating and capital challenges. Over \$6 trillion in federal COVID-19 relief monies was allocated to individuals, businesses, states, cities, school districts, hospitals, airports, airlines, and universities, with mass transit systems receiving \$71 billion, as well as capital monies from the Infrastructure Investment and Jobs Act. With these funds, at least for now, mass transit systems are more secure than they might seem to anyone who has had the pleasure of riding on them recently.

The good news is that most politicians care about mass transit systems and are likely to support investment. Mass transit is widely perceived by voters as an essential public good in urban areas, and it serves a strategic role in facilitating

economic growth, reducing carbon emissions traffic, and promoting equity through transportation connections. Federal money for big transit projects is already on its way, thanks to the overall \$110 billion allocated by four COVID-19 federal stimulus aid packages, including \$40 billion from the 2021 Infrastructure Investment and Jobs Act, earmarked specifically for capital projects.

We believe that there is considerable opportunity in this sector for bondholders, in New York and in other U.S. metropolitan areas. Our expectation is that the Los Angeles MTA, Metro Atlanta Rapid Transit, and others with debt secured solely by regional sales taxes in vibrant economic areas, should maintain their strong and stable outlooks. The New York MTA, which has secure debt and a combination of revenues, including substantial farebox receipts, will also provide attractive investment opportunities, depending on market conditions and the faith of the state to continue to economically support the system.

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



Q&A

with David Golub



David Golub

Editor's note: Evercore Wealth Management supplements its core investment capabilities with carefully selected outside funds across the range of the firm's asset classes. Here we speak with David Golub, President of Golub Capital, which makes loans to middle market U.S. companies owned by private equity firms. Please note that the views of the external managers interviewed in *Independent Thinking* are their own and not necessarily those of Evercore Wealth Management.

Q: Please describe the middle market and Golub Capital's positioning within that market.

A: The middle market generally refers to companies that earn annual EBITDA of between \$10 million and \$100 million. Private equity sponsors typically buy middle market companies with a view toward growth – for example, expanding into new parts of the country, or rolling up smaller competitors. We provide debt financing to help sponsors acquire and grow their portfolio companies. We primarily make floating-rate first lien senior secured loans at conservative loan-to-value ratios, and we focus on minimizing defaults and credit losses.

Q: What do you see as the opportunities and risks for middle market private debt strategies in today's complex environment?

A: Our funds performed well in 2022, despite a bumpy investment environment, and we are cautiously optimistic we will be able to extend that strong performance into 2023. Yes, there are some widely recognized headwinds: Higher rates, inflation, tight labor markets, recent strains in the banking system and a slowing economy mean we are likely to see more credit stress in 2023. There are also tailwinds, arguably more powerful. The combination of higher base rates, wider spreads, lower leverage levels and tighter documentation terms means that the expected return on new loans has increased – and, at the same time, there's a greater margin of safety. Indeed, we believe we are in one of the best environments for making new loans that we've seen in our 28-year history.

Q: When credit spreads rise, as they did in 2022, on loans that are in the portfolio, how is the price of those loans impacted and how is that reflected in the overall portfolio's mark to market?

A: In general, when credit spreads rise in the market, the fair value of existing loans is marked down. Intuitively, the contractual interest rate of the existing loan is below the current market rate for an identical new loan, so a buyer of the existing loan in today's market would demand a discount to face value to make up the difference. This kind of fair value markdown is called an unrealized loss. The good news about unrealized losses is that they don't matter in the long run unless they become realized losses – in other words, if the loan isn't repaid in full. So we are laser-focused on avoiding realized losses. As long as we avoid realized credit losses, fair value markdowns should reverse over time as borrowers pay off, or as their credit attributes improve, or as credit spreads decline in the market.

Q: Do you believe that we will see a significant default cycle in this current economic environment? If so, what steps are you taking to limit defaults and maximize recoveries across the loan portfolio?

A: Last year and the coming period should, in our opinion, give lenders their most important "credit report card" since the financial crisis. Whether there's a recession on the horizon or just more muddling growth, we expect to see greater dispersion in the performance of middle market companies and, by extension, lenders to those companies.

So far, we are pleased with the way our borrowers have adapted to slowing growth and higher rates; the portfolio's performance ratings are strong, and nonaccruals and defaults remain very low. But given the potential for a hard landing, we are also taking extra steps to screen our borrowers for vulnerabilities. We have always believed that early detection of risks and early intervention to mitigate those risks are critical for limiting credit losses. We believe it takes scale and experience to do this well. We're not going to be 100% right – that's not a realistic goal. Our goal is to detect which of our borrowers are at higher risk and then to have early discussions with sponsors and management teams about how to make them more resilient.

Q: Are there any sectors that you think are particularly attractive in this environment? And are there any sectors that you have traditionally invested in that you are avoiding today?

A: Our lending strategy focuses on industries and subsectors that we believe are recession-resistant and where we believe we have deep expertise – industries like mission-critical enterprise software, and veterinary hospitals and specialty distribution. The sectors we think are particularly attractive today are not different from usual. One reason why this matters now is that we expect private equity firms in this uncertain environment to focus less on acquiring new platforms and more on growing their existing portfolio companies. We believe the implication is that there likely should be robust demand for add-on financing from companies in sectors we like where we're the incumbent lender. In terms of sectors we're avoiding, that hasn't changed much either. We tend to avoid industries that are tied to interest rates like home building or auto, or companies that are exposed to volatility in commodity prices or foreign exchange.

Q: A lot of capital has flowed into both private equity and private debt markets over the past decade, but over the last 12 months to 18 months, it appears that capital flows have slowed materially. How should investors think about the outlook for private debt?

A: While capital flows have slowed recently, the stock of private equity dry powder is remarkably high. Reports indicate it is approaching \$2 trillion. As this dry powder is deployed, we expect the private equity ecosystem to double in size. This should lead to large increases in demand for private debt in an environment in which the

amount of private *debt* dry powder is much lower than the amount of private *equity* dry powder. We think the current outlook suggests a sustained supply-demand imbalance that favors lenders.

Within the world of private debt, we see two dominant themes. The first theme is that the big and strong are getting bigger and stronger. This is because private equity firms don't want to have relationships with dozens of lenders – they want to have a core group of relationships with lenders that can do a lot of different things for them. For example, sponsors want to work with lenders that can finance their small deals as well as their large ones, offer a broad suite of creative solutions, bring subject-matter expertise to the table, and scale up as their portfolio companies grow. The second theme is that private debt solutions are gaining share from the broadly syndicated loan market. Growth among leading private lenders has enabled the private debt market to finance larger and larger transactions. And sponsors are finding that these private solutions can be very attractive for a whole range of deals that until recently would have been done in the broadly syndicated market – deals where there's a critical component like confidentiality, certainty of execution, or capacity to grow over time that the broadly syndicated market just isn't well suited to deliver. Both of these dominant themes play to the strengths of leading large-scale lenders.

For further information, please contact Evercore Wealth Management Partner and Portfolio Manager **Stephanie Hackett** at stephanie.hackett@evercore.com.

Selling Your Company? Don't Leave Money on the Table

By Justin Miller

The author Zig Ziglar once said, “Money isn’t the most important thing in life, but it’s reasonably close to oxygen on the ‘gotta have it’ scale.” Still, a business owner caught up in the stress and time-consuming work of negotiating and structuring the sale of their company can lose sight of what the transaction can mean at the personal level. It’s time to take a deep breath and consider this possible once-in-a-lifetime opportunity to maximize personal after-tax profits; minimize income, gift, estate, and generation-skipping transfer taxes; accomplish charitable goals; and protect assets.



A successful transaction starts with a collaborative team of advisors – which can include investment bankers, attorneys, accountants, and strategic wealth planning advisors – all working together to prepare the business owner for the liquidity event and to maximize the value, speed, and certainty of the transaction closing. By combining tax, estate planning and business succession strategies, we believe business owners will have the greatest opportunity to maximize the wealth from the sale of their business.

With strategic wealth planning, the resulting savings can be significant – and the earlier you start, generally, the better the results can be. However, the sheer number of potential planning strategies can be overwhelming and easily lead to planning paralysis. For example, options could include intentionally defective grantor trusts, grantor retained annuity trusts, completed gift non-grantor trusts, incomplete gift non-grantor trusts, spousal lifetime access trusts, asset protection trusts, charitable trusts, family limited partnerships, family limited liability companies, qualified opportunity zone investments, qualified small business stock stacking, installment sales, discounting, recapitalization, estate freezes – it's enough to make almost anyone's head spin!

A successful transaction starts with a collaborative team of advisors

So, how can Evercore Wealth Management help? Consider the recent experience of a California-based couple, described on page 14, who were able to successfully close their private transaction in a tax-efficient manner while creating a lasting legacy for their

Selling a business is a challenging, and often exhausting, transition

family and charity. By adding a wealth advisor to their collaborative advisory team, the couple successfully eliminated \$45 million of the sale proceeds from being subject to federal income taxes, as well as \$35 million from being subject to state income taxes, deferred an additional \$10 million from both federal and state income taxes, generated a \$6 million charitable income tax deduction, and created a lasting legacy for their family that provided both asset protection and the ability for assets to grow free of gift, estate, and generation-skipping transfer taxes in perpetuity.

Selling a business is a challenging, and often exhausting, transition. But it's important to make time, as early as possible, to ensure that a strategic wealth plan is structured to maximize the potential advantages of the transaction. After all, this life event is often the result of many years of hard work and sacrifice. In short, don't leave any money on the table.

If you are selling your company, consider contacting a Wealth and Fiduciary Advisor at Evercore Wealth Management and Evercore Trust Company, N.A., who can work with you, your family, and your team of advisors to help protect your wealth, your legacy, and your family's values for future generations.

Justin Miller is a Partner and National Director of Wealth Planning at Evercore Wealth Management. He can be contacted at justin.miller@evercore.com.

Wealth Planning When Selling a Business: One Couple's Experience

A California couple was so caught up in the approaching sale of their private technology business that they almost canceled the meeting with the wealth advisor recommended by their investment banker. They already had done some estate planning years ago by funding an irrevocable intentionally defective grantor trust, or IDGT, for their children, and while they knew it was a good idea to consider other estate planning strategies, they thought it could wait. But in the end, they took the meeting.

The first thing this couple's new wealth advisor discovered while reviewing their financial and estate planning documents was that a required gift tax return was never filed for their existing IDGT. After working with their attorney and accountant to rectify that issue, the wealth advisor prepared easy-to-follow flowcharts and detailed financial projections for the couple to consider additional tax planning options.

Next, the wealth advisor recommended setting up three new irrevocable non-grantor trusts in Delaware for the benefit of each of the couple's adult children and any future grandchildren. Unlike their IDGT, each of those new non-grantor trusts qualified for a \$10 million exclusion from both federal and state income taxes by taking advantage of section 1202 of the Internal Revenue Code with respect to qualified small business stock, or QSBS. As a result of the QSBS planning, the couple was able to exclude a total of \$40 million of proceeds from federal income taxes – that is, \$30 million with the non-grantor trusts and \$10 million personally. And even though they lived in a state that does not have a similar QSBS exclusion at the state level, the three non-grantor trusts based in Delaware also were able to avoid state income taxation on \$30 million in gains. In addition, by using their remaining lifetime exemption amount, which is \$25.84 million per couple in 2023, those trusts' assets and all the future growth of the assets will remain protected from creditors and free of gift, estate, and generation-skipping transfer taxes for multiple generations.

After their wealth advisor walked them through various philanthropic planning options, the couple decided that a private foundation was not worth the extra administrative burden, but they did decide to set up a donor-advised fund with \$5 million of their company stock. Not only did that charitable gift generate a \$5 million tax deduction – which was used to offset their ordinary income from salaries, bonuses, and exercise of stock options – but the gift also protected the family from paying any capital gains on the sale of that stock. In addition, the couple funded a charitable remainder trust, or CRT, with \$10 million, which generated an additional \$1 million charitable deduction, deferred federal and state income taxes, and should provide an annual payment of 7.7% of the value of the trust to the couple for the rest of their joint lifetimes (projected to be \$21 million pre-tax over 32 years with an assumed 7% return). Everything remaining in the CRT after both their deaths (estimated to be \$7.2 million with that assumed 7% return)¹ would go to their donor-advised fund, which their children would then be able to participate in giving away to charities during their lifetimes.

As part of the comprehensive wealth planning process, the wealth advisor also made sure that the couple had a short-term cash management plan in place to protect the post-transaction proceeds, generate interest, and cover the federal and state income taxes that would be due on the transaction. The wealth advisor included a senior portfolio manager as part of the wealth management team to help this couple create an initial goals-based investment policy statement that would help guide their long-term investment strategy and overall asset allocation, taking into account both the location and structure of all their assets across various family trusts and business entities.

Last, the wealth advisor facilitated the couple's first family council meeting, in which their adult children had an opportunity to learn more about the various planning structures, and the family could communicate about how the substantial proceeds from the sale of the company would be used to support the family's values and future legacy.

– Justin Miller

¹ Estimated returns are based on a balanced asset allocation and net of fees.

All in the Family: Planning with Sprinkling Trusts

By Kate Mulvany

Each sibling, they say, experiences a different family. That's true for their parents too, as they watch each of their children grow as individuals, so different from their brothers and sisters, no matter how close in age or how much the parents strive to treat them equally. And just when parents think they have figured out each child, they can change again, as subtle differences in temperament and experiences compound. The valedictorian wants to take a gap year or more to travel with his band; the athlete is injured; a hitherto easygoing child starts to struggle – anything can happen. So how can parents (and grandparents) of more than one child plan accordingly?

This subject – fair versus equal in wealth management – has many important aspects, all worth considering in depth. (See page 16 for links to some of our related recent publications and webinars.) But let's concentrate here on one potential solution, for parents and grandparents considering their estate planning. A family sprinkling trust, also known as a pot trust, provides a way for grantors to benefit a class of individuals – typically children, grandchildren, and further descendants – assigning funds to a class of people instead of to specific individuals. It's a pooled family asset, available to each member according to

their needs at the discretion afforded to the trustee(s) by the grantor.

Typically, parents and grandchildren set up a sprinkling trust to make gifts to very young children, who will likely not need to access the trust assets or income for some time. (The trust can also provide for the surviving parent in the class.) While the trust could remain a single pot forever, it will more likely remain collective until the ages by which the children will have likely completed their educations and begun their careers and families of their own. At that time, the trust could be split, or divided into

separate trusts – for each child, their descendants, and their spouses – as the grantors see fit. Or the sprinkling trust could remain intact, to accommodate careers with very different earning potential, for example. The investment banker and charity worker are likely to face different challenges – although, again, anything can happen.

In the interim, the trust structure allows a young family to adjust for different and changing circumstances. A child with special needs will almost certainly require relatively more support. But other differences could be appropriate reasons

Fair versus Equal: Recent related webinars and publications

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Publications

- “Equal or Equitable: What is Fair?” by Jeff Maurer
- “Lending Support & Advice to the Next Generation” by Jeff Maurer
- “Health & Wealth” by Jeff Maurer
- “Encouraging Next-Generation Success” by Jeff Maurer
- “Special Needs Trusts: Protecting the Whole Family with Wealth Planning” by Karen Francois and Jay Springer
- “Gifting and Letting Go: Emotional and Practical Perspectives” by Justin Miller

to disperse funds; for example, one child may really benefit from private school while the other is thriving at public school, at least for now.

Sprinkling trusts can be very helpful for blended families, in which children may be spaced farther apart in age. The structure allows for the younger beneficiaries to access funds for education and other needs that may have already been met for the older children. The distribution won't be equal, but it will be fair. A Connecticut-based couple discovered that recently, when they set up a sprinkling trust for their blended family, with five children spanning seven years in age, two with mild development disorders. The couple decided that a sprinkling trust benefiting the survivor and all the children until the youngest reached 30 years old made the most sense. At the death of the survivor, the balance of the trust (provided the children are all 30) will continue in separate trusts for each of their children and, secondarily, for their children, with the same provisions.

This couple's trust, like most well drafted trusts, allows for an independent trustee to make

discretionary allocations as needed, to protect each member and maintain family harmony. Many families opt to include a Limited Power of Appointment in their planning documents. This allows for the primary beneficiary, say a surviving spouse, to appoint the shares unequally or in different trusts that meet changed circumstances. The situs of the trust is also important. Delaware situs trusts can provide even more flexibility, allowing a specially appointed person (a “trust advisor/protector”) to make changes during the term of the trust that would accommodate needs that were unknown when first drafted.

Sprinkling trusts are a good solution for many families

Trusts also need to be properly managed. Investment and management decisions for a trust designed to serve children and potentially future generations generally shouldn't be that dissimilar from a thoughtful, sophisticated, goals-based investment process. Risk/return trade-offs, cash flow requirements, and income tax

status need to be evaluated much like an advisor would do for individuals. Investment vehicles that were once the preserve of institutional investors can now be used to complement the overall strategy of the trust and to grow wealth as well as to protect it.

Most important, the trust is flexible; it can change as the family's circumstances evolve, as they surely will. The valedictorian's band tour could become the start of something big – or an anecdote in a life well lived. And his siblings will have their own – and likely very different – setbacks and successes. The trust needs to be flexible enough to honor its stated purpose, but also the true intent of the grantor, to treat the children fairly. A fully discretionary trust that will last for generations, places a lot of responsibility on trustee(s) now and in the future. Future trustee(s) must be able to carry through the intentions of the grantor(s) in making disbursement decisions across an expanding class that could potentially threaten family harmony.

All told, sprinkling trusts are a good solution for many families. They provide protection for potential spendthrifts, from creditors (including divorcing



\$12.92 MILLION

Current federal estate, gift, and generation-skipping lifetime exemption per person

spouses), and for family members with special needs. They also provide a vehicle that can be sheltered from future federal estate and generation-skipping taxes, subject to very careful consideration.

Finally, keep in mind that the current federal estate, gift, and generation-

skipping tax lifetime exemption is now \$12.92 million, or double that for a married couple, but is scheduled to revert in 2025 to about \$6.2 million, indexed for inflation. Transfer strategies should only be executed in the context of long-term plans, but there is good reason now to accelerate those plans.

Kate Mulvany is a Partner and Wealth & Fiduciary Advisor at Evercore Wealth Management. She can be contacted at mulvany@evercore.com.

Successful Succession Planning: A Continuous Process

By Jeff Maurer

Two companies are created by men born 111 years apart. The first, Cargill, a producer and distributor of agricultural products, becomes one of the largest and most successful private companies in the world, still family owned. The other, Microsoft – well, you know. So, what do these two companies have in common, apart from being built by men named William? They both struggled and ultimately succeeded, in very different ways, with the issue that vexes every lasting concern – succession.

As an advisor for 50 years to business owners, executives, and multigenerational families, I have observed that succession planning should be viewed not as a one-time event, but as a continuous, evolving process. Most big companies develop a pool of talent and observe that talent over time. If the company or family is doing well, internal promotions can be the best path to continuing success. If the business is faltering, turning to the outside generally produces better outcomes. According to a recent analysis published in the *Harvard Business Review*, the amount of market value wiped out by badly managed CEO and C-suite transitions in the S&P 1500 is close to \$1 trillion a year.¹ The report estimated that

better succession planning could add 20% to 25% to company valuations and investor returns.

That's true for small businesses and for families too, as succession planning enables functions to be passed from one leader to another, recruiting from the outside and appointing independent trustees as needed. When the 74-year-old Charles is crowned King of what his father described as "the firm" on May 6, it will mark the latest stage in a planning process that really started in 871 with the succession of Alfred the Great. (It may also highlight some of the pitfalls of designating a successor merely by birthright.) While most of us don't aspire to this grandeur, many of us would like

to identify the right future stewards of our wealth for our families and our businesses.

On a personal note, succession planning was a big issue at my earlier firm, where on my first decade there were four chief executives, which during that time diminished the value of the firm. But the last of the four was a great success, and when he reached mandatory retirement age at 65, he promoted me to president at age 42, as part of a well-planned succession process. All of this was very much on my mind when I helped found Evercore Wealth Management at the age of 61, with a view to running the firm for 10 years. Over time, I worked with Evercore senior management to identify and prepare my successor. When the time came, we had a smooth

¹ A version of this article appeared in the May-June 2021 issue of *Harvard Business Review*.

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and successful transition to Chris Zander, one of our founding partners, and I was able to stay on as a nonexecutive chairman, which works well for us and, I believe, for our clients.

In a similar vein, we actively and continuously plan for the evolution of our firm, as partners and other professionals retire – to ensure that our values and culture, as well as our expertise, are carried forward, and our clients have time to work with and approve our suggested successors. And we encourage our clients to ensure that their other advisors – whether attorneys, accountants, doctors and the like – also have succession plans in place. You probably don't want to get old with your dentist.

*The earlier we plan
for succession,
the better the outcome*

As for the two Williams and their somewhat larger companies, I imagine that William Wallace Cargill would be gratified to know that 158 years after its founding as an Iowa grain-storage business, his company remains in family hands, perhaps because subsequent generations realized that its affairs had become far too complex and turned to outside management starting in the 1960s. Indeed, 14 members appear to be billionaires, making the family the fourth wealthiest in the United States. If Cargill were a public company, it would be among the largest in the country and perhaps among the most controversial – but that's another story.

William Henry Gates III, better known as Bill, is probably relieved to focus on his philanthropic interests after the six-month crisis back in 2013 when his successor, Steve Ballmer, announced that he was quitting and the scramble for his replacement resulted in the internal promotion of Satya Nadella,

a 21-year veteran of the firm – and a subsequent 30% gain in the company's stock price over the next 16 months.² Two very different companies, two very different succession solutions after periods of arguably unnecessary turmoil, but in the end the right choice for each.

² 7/31/2013 - 11/30/2014.

In our view, the earlier we plan for succession – and the more we continue to invest in it – the better the outcome.

Jeff Maurer is the Chairman (and former CEO) of Evercore Wealth Management and Evercore Trust Company. He can be contacted at maurer@evercore.com.



OFFICES

NEW YORK

55 East 52nd Street
New York, NY 10055
212.822.7620

Jay Springer

Partner

212.822.7621

springer@evercore.com

MINNEAPOLIS

150 S. Fifth Street, Suite 1330
Minneapolis, MN 55402
612.656.2820

Martha Pomerantz

Partner

612.656.2821

martha.pomerantz@evercore.com

PALM BEACH

515 North Flagler Drive, Suite 702
West Palm Beach, FL 33401
561.812.1010

Michael Cozene

Partner

561.812.1010

michael.cozene@evercore.com

SAN FRANCISCO

425 California Street
Suite 1500
San Francisco, CA 94104
415.288.3000

Keith McWilliams

Partner

415.288.3010

keith.mcwilliams@evercore.com

TAMPA

4030 Boy Scout Boulevard, Suite 475
Tampa, FL 33607
813.313.1190

Julio Castro

Partner

813.313.1192

julio.castro@evercore.com

WILMINGTON

Evercore Trust Company, N.A.
300 Delaware Avenue, Suite 1225
Wilmington, DE 19801
302.304.7362

Alexander Lyden-Horn

Director of Delaware Trust Services
and Trust Counsel

302.304.7369

alexander.lydenhorn@evercore.com

EDITORIAL AND MEDIA

Aline Sullivan

Editor

203.918.3389

aline.sullivan@evercore.com

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