Brown ADVISORY
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The Advisory

INVESTMENT OUTLOOK FOR PRIVATE CLIENTS

MARCH 2016

PHOTO: STEVECOLE/IMAGES/E+/GETTY IMAGES

STEADY HAND

So far in 2016, investors have encountered some of the worst market turbulence in many years. The key to weathering the volatility is staying true to a long-term investment plan.

THROUGH THE STORM

Stock market volatility has spiked in response to immediate market concerns about energy prices, weakening economic growth in China and changes to monetary policy, as well as momentous capital-market shifts during the past 20 years. In times like these, investors earn their stripes by staying focused on their long-term goals.

This year, financial markets are grappling with a long list of pressing questions. In January, China said that the nation's economy grew 6.9% in 2015, its slowest pace in 25 years, and concerns abound about the prospects for its expansion because of debt-laden state enterprises and excessive spending on real estate and infrastructure. The collapse of oil prices—Brent crude prices have fallen from more than $100 in mid-2014 to a $30-$35 range today—has jolted the industrial sector. Everyone from oil drillers to private equity and debt fund managers to media pundits are spinning in all directions with predictions of recovery or recession. The vast divergence of views has prompted speculation about the pace of the Federal Reserve's plan to increase interest rates.

Will China's slowdown worsen? Will the U.S. expansion falter? Will the price of oil fall and perpetuate the slow-motion implosion in the energy industry? When will the Fed next raise interest rates? Will an "anomaly" flash crash hit equity markets today?

The honest answer is, we don't know. We rarely, if ever, can predict the short-term twists and turns in the economy. We do know that reacting strongly to short-term fears about the unknown is most often a mistake. We believe that investors are most likely to reach their goals by focusing on the long term: relying on fundamental research, allocating capital to truly exceptional investments and staying true to a comprehensive plan.

COSTLY CONVICTION

Successful investing requires some degree of humility. According to "Freakonomics" partners Stephen Dubner and Steven Levitt, "I don't know" are, together, the three hardest words for most people to say. In their 2014 book, *Think Like A Freak*, they talk about our reluctance as a species to say these words. Academic research suggests that the inhibition may be wired in at an early age. In a variety of studies, from 60% to 75% of kids between 5 and 8 years old give "yes" or "no" answers to yes/no questions even though they don't know the correct response.

As investors, we strive to constantly remind ourselves about this human tendency. The fact is that more often than not, we cannot answer questions that would help us predict the movement of

BY PAUL CHEW, CFA
Head of Investments

the market. Being humble is essential to our long-term investing mindset. Indeed, we know that many of an investor's worst decisions result from convincing yourself that you know something when you don't.

Given the breadth of the uncertainty currently weighing on the market, it isn't surprising to see higher volatility. In January, the Standard & Poor's 500 Index traded up or down by more than a percentage point during 13 out of 19 trading days, ending up with a 5.1% decline for the month. During periods like this—when the economy feels unpredictable, when you don't know exactly what is coming next, when you are most tempted to deviate from long-term plans—it is especially important to stick with those plans and resist the temptation to overreact to short-term turbulence. As we think about rising market volatility, we should first acknowledge that the market's choppiness during the past year is not out of whack with recent years. As shown by the chart on page 4, we are really looking at a tale of two eras: one exhibiting a baseline of volatility from 1970 until 2000, and the other showing meaningfully higher volatility from 2000 to the present.

LOOK BACK LONGER

So rather than ask why markets are especially volatile this year, it would be more illuminating to look at why markets have been more volatile during the past 20 years. We think about the changes we've seen in recent decades in three broad categories: informational, structural and regulatory.

Informational: When it comes to investment information, we all suffer from an acute case of "too much information." CNBC shouts at us 24 hours a day, and the most miniscule events are immediately reported in stories all over the Internet seconds after they happen. The barrage disrupts an ability to weigh the import of any individual piece of information. Equally important, the advent of high-frequency trading (HFT) has completely collapsed the relevant time horizon for 99.9% of the investment transactions completed every day. HFT firms execute hundreds of thousands of trades each second for a single customer, just to jump on momentary price dips of a fraction of a penny. Last year, the scientific journal *Nature* published "Physics in Finance," an article that reported on advanced laser and "hollow core" technologies that are accelerating the transmission of trade data by milliseconds. The new speed limit for investment decisions is the speed of light. Against that backdrop, we need to accept the idea that the "flash crashes" of recent years may simply be a new, permanent characteristic of market behavior.

Structural: High-frequency trading is evidence of a structural shift in capital markets as much as an informational shift. During most of the period since World War II, the stock market responded much more to the decisions of patient, long-term-oriented decision-makers than it does today. The people who influenced capital flows and advised or influenced other investors were the likes of Warren Buffett, Philip Fisher and Peter Lynch—each with a differentiated approach but a common focus on the long term and on fundamental research. Their common strategy was simple: Buy good companies and hold them for a long time.

Today, most investors do not see themselves as patient owners of companies. Far more often, investors simply "buy the market" via index mutual funds or ETFs, meaning their every investment decision involves hundreds of stocks, not just one stock. Also, reduced barriers to trading have drastically increased the number of people making trades and the speed with which they trade. This includes self-directed retail investors as well as institutional, high-frequency traders. Moreover, sovereign wealth funds, managing the assets of countries such as Norway ($882 billion), United Arab Emirates ($773 billion) and Kuwait ($592 billion), roil markets with huge trades prompted by sudden shifts in other markets. Stock market volatility this year has been ascribed in part to selling by sovereign wealth funds seeking to make up fiscal shortfalls created by the collapse in oil export revenues.

Regulatory: Finally, regulation and central-bank activity has heavily influenced markets since the

2008-2009 financial crisis. For years, central banks around the world have supported their economies and capital markets by cutting interest rates to record lows and purchasing government bonds. As a result, markets are now hypersensitive to any hints of monetary policy changes and interest rate movement. What's more, due to this already sustained offensive, central banks have less ammunition today to respond to further market downdrafts.

Another less widely discussed factor is the fear that liquidity in certain markets—specifically the corporate bond market—is drying up. Traditionally, banks have been the primary intermediary dealers of corporate bonds, but because of various post-crisis regulatory shifts such as the Volcker Rule and generally stricter capital requirements, bond dealing is far less attractive for banks. They have been reducing their market-making presence and dealer inventories for years. The risk is clear: If no one is there to buy when others are selling, the market's movements will be more volatile. It is too soon to say how powerful this trend will be over time.

FUNDAMENTALS STILL RULE

These informational, structural and regulatory changes intensify short-term volatility in prices during a typical day or month. In our view, the best response can only be to acknowledge increased short-term uncertainty, and to redouble our focus on long-term goals and market drivers. Even if we do see bigger and more frequent market swings in the coming years, the basic rules of patient and value-conscious investing have not changed. Companies that can grow their earnings consistently over a 10-year period should still be worth more at the end of those 10 years. Bonds with healthy credit profiles will probably still provide investors with consistent income and eventually return those investors' principal at the end of their term. And investors who do an outstanding job of identifying great investments—in other words, situations when there is an attractive spread between the price of a stock or bond and the long-term value of the underlying business—should still have the potential to create wealth over time.

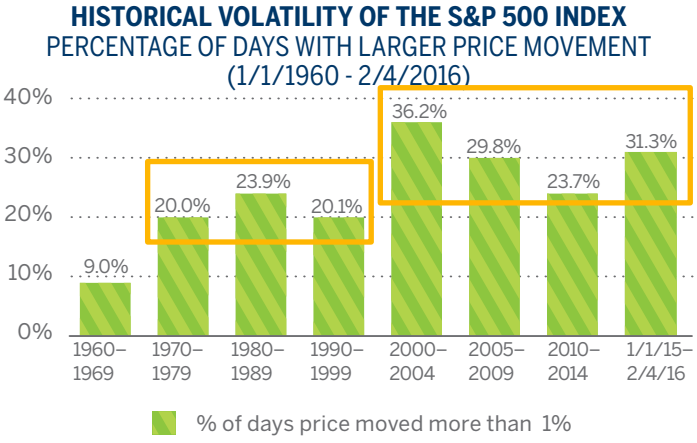
In the current investment climate, we are certainly not ignoring the risks and opportunities presented by the market's volatility. During the past 12 months, we have shifted to a slightly more defensive position in client portfolios. We have reduced our weighting in equities overall, and in U.S. equities in particular, while adding to weightings in assets with lower risk profiles than equities, such as high-yield bonds as well as some private credit opportunities where appropriate for clients. We are actively monitoring situations where we feel the pendulum may have swung too far. High yield is a good example of a situation where recent uncertainty—in this case over the price of oil—has led to a major sell-off across the entire high-yield market, creating potential opportunities among bonds whose prospects actually have little to do with energy prices. We maintain allocations to emerging markets during a period when they have struggled mightily, but our managers have performed well on a relative basis and we still see excellent long-term potential for growth in these markets as their middle classes mature in coming years.

We always maintain a posture that balances upside potential, downside protection and appropriate liquidity in client portfolios, as dictated by each client's circumstances. We focus on a "three-bucket" approach—which customizes each client's mix of short-term cash balances, core portfolio and opportunistic investments—to ensure a consistent framework for long-term investing that works for clients practically and emotionally under all market conditions. Any tactical allocation decisions are made within the context of that overall long-term portfolio framework.

Why? Because we don't know what is going to happen in the short term, so we always need to be prepared for a variety of short-term positive and negative outcomes. Over the long haul, however, if we stay true to our investment philosophy—maintain a long-term investment horizon, focus on fundamental research and, above all, invest in what we know and understand—we are confident that we can help our clients achieve the results they seek over time.

Millennial Madness

Surges in volatility by the Standard & Poor's 500 Index have become more frequent since 1960. The higher figures since 2000 point to the impact of long-term trends instead of a rise in investor skittishness since the 2008-2009 financial crisis.



SOURCE: BLOOMBERG

A Lift Amid Headwinds: The Appeal of Mortgage Bonds

With the Federal Reserve tightening for the first time since 2006, investors may generate competitive returns from the comparatively stable market for mortgage-backed securities.

BY TOM GRAFF, CFA
Head of Fixed Income

JOHN HENRY IUCKER
Fixed Income Research Analyst

"Know your borrower!"—a lesson from the subprime mortgage meltdown last decade—is now the key to achieving outperformance through investing in the even-keeled market for government-backed mortgage bonds.

In normal times, agency mortgage-backed securities (MBS) generate more income than U.S. Treasuries because borrowers compensate investors for the risk that they will refinance their mortgage and force prepayment of the securities at a loss of the premium paid at purchase. But these are better-than-normal times for MBS. These bonds are especially appealing today as the Federal Reserve embarks on a policy to nudge up benchmark interest rates from record lows. Policymakers, including Fed Chairwoman Janet Yellen, have said that the pace of tightening will probably be slower than usual. With interest rates flat or gradually rising, homeowners are less likely to refinance but still must compensate investors for the option to do so. That means we should see fewer MBS prepayments and a solid return for investors.

We seek to outperform by analyzing individual MBS at a granular level and identifying bonds with a comparatively low risk of prepayment. Such bottom-up analysis differs from the approach of most investors, who view MBS as homogenized securities with limited differences in risk. We seek to profit by buying MBS that we believe pose less risk than the market perceives and pocketing the extra yield offered for the higher estimated risk. When scrutinizing MBS, we look for the following signs of lower prepayment risk and higher potential return:

New mortgages. Homeowners who have recently closed on a mortgage rarely plan to refinance anytime soon. By purchasing MBS with a higher percentage of fresh mortgages, we push back our estimated date of a prepayment.

Small loans. When interest rates decline, homeowners who refinance small mortgages would likely reduce their monthly payments less in dollar terms than borrowers with larger loans. Ergo, they have less of an incentive to take advantage of lower rates with a refinancing. Also, fixed fees for refinancing pose a bigger disincentive to borrowers with smaller loans.

High loan-to-value ratios. Homeowners with minimal equity in their properties have difficulty refinancing mortgages because lower down payments in percentage terms usually prompt higher borrowing rates.

Lower credit scores. Homeowners with low credit scores often have difficultly accessing credit and will have to pay higher interest rates than borrowers with better credit scores. Refinancing may not be an option for them, and would become even harder to secure when interest rates rise.

By poring over thousands of MBS in search of the attributes listed above, we built a portfolio that outperformed the 1.51% return of the Barclays Mortgage-backed Securities Index last year. Much of the excess return stemmed from the slow rate of refinancing in the MBS pools we own. In 2015, our portfolio's constant prepayment rate (CPR)—an annualized percentage of borrowers who terminate their loans—was 5.0% compared with 14.6% for the universe of bonds with comparable coupons. Mortgage borrowers pay MBS investors higher yields in order to have the option to pay off the debt before its stated maturity. Each incremental dollar not refinanced over a given period means fewer prepayments of principal at face value. (The vast majority of MBS trade above face value.)

At the core of our strategy is an awareness that MBS are not bloodless blocks of bonds but pools of mortgages, each with a living, breathing borrower behind it. Every borrower takes a distinct approach to homeownership and personal finance. By vetting each MBS from the bottom up, mindful of these nuances and looking for clues to borrower behavior, we seek to achieve attractive investor returns. B

'The Ultimate Mobile Device': Redefining the Automobile

For more than a century, automakers have provided a way to find adventure and new possibilities just beyond the horizon. Now the industry is also trying to satisfy consumers' Web-focused wanderlust.

Global automakers—latecomers to the digital highway—are now trying to hog its fast lane. Industry behemoths ranging from Volkswagen to Toyota to General Motors are pouring money and talent into boosting auto connectivity: building self-driving cars, upgrading safety, investing in ride-sharing services and creating "electronic horizon" navigation that peers ahead to report on myriad details, including weather, traffic congestion and the contours of the road.

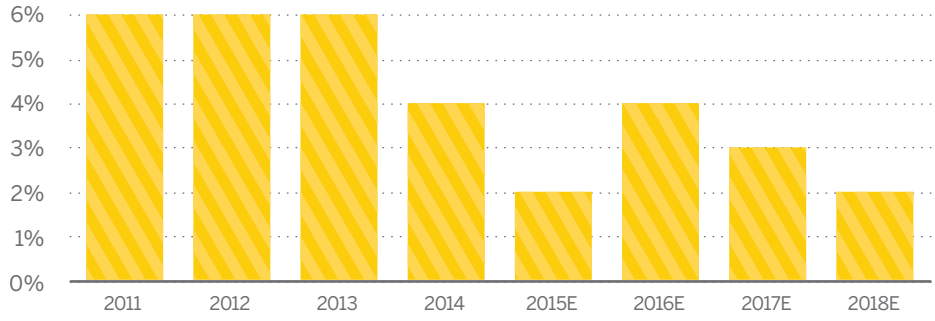
"The car is and will remain the ultimate mobile device," Herbert Diess, CEO of Volkswagen's passenger vehicle unit, said in January at the annual Consumer Electronics Show. Autos will eventually become "the most important device on the Internet," Diess predicted in Las Vegas while showcasing the BUDD-e, an electric van that responds to voice commands and links to a home's appliances, lights, communications, heating, cooling and security systems.

By redefining the car, the Old Economy auto industry aims to ride consumer and investor enthusiasm for Web-based innovation and beat back forays into the sector by info-tech powerhouses such as Apple and Google. We expect the advance into digital will do little in the foreseeable future to overcome the industry's toughest challenges, including overcapacity, tightening regulations and sputtering sales growth. So rather than invest in highly-cyclical automakers, we are buying shares in companies that provide the sector with the software and hardware for its digital initiatives.

The race to develop the connected car is speeding up:

- A consortium of Daimler, BMW and Volkswagen's Audi unit bought Nokia's HERE mapping business in August for about $2.8 billion. Combining cloud-based technology with high-definition maps, HERE is a building block for driverless cars, applicable also to smartphones and tablets.
- GM announced in January it will invest $500 million in Lyft, a privately owned ride-sharing service valued at about $5.5 billion and backed by Alibaba, Andreessen Horowitz and Carl Icahn. GM is downplaying horsepower and instead emphasizing the integration of cars with infotainment apps such as Spotify.
- Toyota, the world's top automaker in sales, said in November it plans to spend $1 billion on research into artificial intelligence as part of its development of an autonomous car by 2020.
- Ford, after announcing in December a $4.5 billion plan to develop electric vehicles, said in January it will make its vehicles

PERCENTAGE GROWTH IN GLOBAL AUTO SALES
(1/1/2011 – 9/30/2015, WITH ESTIMATES TO 12/31/2018)



SOURCE: MORGAN STANLEY

Sputtering Sales

Growth in worldwide sales of automobiles has slowed in part because of faltering demand in emerging economies, incuding Brazil, China and Russia.

BY SIMON PATERSON, CFA
Equity Research Analyst

compatible with the automotive operating systems developed by Apple and Google.

- Tesla, while challenging automaker heavyweights with its electric car, is advancing a self-driving system dubbed Autopilot, which deploys radar, cameras, ultrasonic sensors and digital data to steer, change lanes and alter speed in response to traffic.

The spread of digital technology is not the biggest immediate threat to automaker profitability. Slowing economic growth in emerging economies such as Brazil is slamming the brakes on growth in global sales. (Please see table on page 6.) The whiplash from decelerating growth was especially harsh last year in China, the biggest market for new cars with more than 20 million in annual sales. U.S. auto sales this year may not exceed the record in 2015 of 17.5 million.

Also, regulatory costs will probably rise. Volkswagen in January started recalling nearly 11 million diesel-powered vehicles worldwide in one of the biggest product recalls in the automotive industry's history following a disclosure that it rigged engines to cheat on emissions tests. The finding is prompting stiffer regulation in Europe and beyond. Volkswagen has made a provision of $7.5 billion globally for the recalls and faces billions of dollars in litigation and fines.

Although a threat to Old Guard automakers, the digitally equipped car is a boon to consumers. When fully deployed, autonomous cars could bring $5.6 trillion in worldwide annual savings from several benefits, including reduced fuel consumption, higher passenger productivity, and less accidents and traffic congestion, according to Morgan Stanley. In the U.S. alone, the savings could total $1.3 trillion.

We are finding opportunities in companies that are profiting from the sector's plunge into digital technology by developing the car's central nervous system. For example, Google—whose parent company is Alphabet—began developing a driverless car last decade based partly on its advances in Google maps and artificial intelligence. Its cars have logged more than 1 million miles on U.S. roads. In February, the National Highway Traffic Safety Administration issued a letter backing the company's view that an autonomous car is as safe as a human-controlled vehicle. We believe that Alphabet's stock does not yet reflect the value of its driverless car initiative. Improvements in financial disclosure prompting transparency on such "moonshot" projects could boost company shares as investors recognize the potential of game-changing markets like autonomous vehicles.

TE Connectivity, the top supplier of auto connectors with a 40% market share, is gaining from increased demand for auto safety and fuel efficiency. Its products are at the core of several features, including airbags, anti-lock brakes, parking-assist cameras, collision alarms, lane-departure warnings, stability control and head-up displays. TE last year bought Measurement Specialties, a manufacturer of sensors, doubling its potential market opportunity to about $400 per car. Amphenol, which also focuses on electronic sensors and connectors, derives 20% of its sales from the auto industry, with annual growth from the sector at close to 10%. The company is known for shareholder-friendly use of capital.

Since it first rolled off an assembly line, the automobile has been a cherished apparatus for escape. Today, we are investing in companies that help ensure drivers can go where they want in their car while remaining right at home on the Web.

Present at the Creation: Early-Stage Venture Capital

While headlines often focus on Uber, Airbnb and other private companies valued at more than $1 billion, we are looking beyond the so-called unicorns to find opportunities for bigger returns in early-stage venture capital.

In 2011, a Tel Aviv-based startup called Cyvera began developing cybersecurity software deploying the coding equivalents of barriers and traps to thwart hackers staging potentially devastating "zero-day attacks." In October 2012, a $1 million investment was enough to buy 13% of Cyvera. Less than two years later, Palo Alto Networks purchased the company for $200 million—a more than 25-fold surge in valuation.

In November 2015, Square, a San Francisco-based creator of mobile payment technology, went public at $9 per share and immediately rocketed 45% to a valuation of more than $4 billion. Great news for investors, right? Not necessarily. The prior year, Square had raised venture financing that put its value at $6 billion. Investors in that round suffered meaningful paper losses on their investment.

The contrasting fortunes of Square and Cyvera underscore our belief that investors today can find more promising opportunities in early- rather than later-stage venture capital. From 2010 until 2015, the bull run in publicly traded equities led to a surge in valuations across the venture capital industry. Increasing amounts of capital were raised to take advantage of the breakneck pace of innovation. Hedge funds and mutual funds also seized on venture capital opportunities like never before.

The flood of cash has centered primarily on late-stage, venture-backed private companies. Indeed, in 2013, the nickname "unicorns" was coined for privately owned companies with a market value exceeding $1 billion. Today, such companies are not as rare as their name suggests: As of Feb. 23, 2016, there are 153 unicorns worldwide with an aggregate value of $537 billion compared with just eight such firms with a total value of $21 billion in 2010, according to CB Insights, a New York-based research firm.

The term "private IPO" became ubiquitous last year, as entrepreneurs obtained private funding at points in their companies' life cycles that in previous decades would have necessitated an IPO. Indeed, before the dot-com bubble burst in 2000, IPOs were considered financing rounds. In 1999-2000, companies staged an IPO at an average age of 5. Today, many entrepreneurs view IPOs as a liquidity event or an opportunity to exit—the final stage in company growth. The average age of a company executing an IPO has jumped to 11, underscoring that companies going public are much more seasoned than they were a decade ago.

Amid the boom of later-stage venture capital, early-stage valuations have risen more modestly. Since 2010, later-stage financing rounds, beginning from Series D and beyond, have nearly tripled, from $64 million to $184 million. Meanwhile, valuations across seed-stage financings—the earliest entry point for private investors into venture companies—have doubled from $3 million to $6 million. Valuations across Series A rounds have grown by 150%—from $6 million to $15 million. (Please see table on page 9.)

ELEVATED EXITS

We believe that investment today in early-stage companies is more likely to meet the baseline expectation among venture capital investors for a fivefold to 10-fold gain over a five- to eight-year period. Later-stage investors face a significant challenge to achieve sufficient returns to justify taking on the level of risk: the valuations are simply too high. Venture-backed technology companies from 2010 until early 2015 exited in general at valuations from about $100 million to $200 million, according to CB Insights, highlighting our belief that investors should focus on seed and Series A investments to achieve a requisite return.

Accessing the most promising opportunities in early-stage venture capital has always been a challenge. At Brown Advisory, we tap into a network that is rooted in our legacy with Alex. Brown & Sons, the lead underwriter for iconic consumer and technology companies such as AOL, Starbucks, Qualcomm, Sun, Oracle and Microsoft. We are still close to many of the investment bankers who helped finance those companies. They are dispersed

BY JACOB HODES
Co-Head of Private Equity

KEITH STONE
Private Equity Venture Analyst

across Silicon Valley and other proving grounds for entrepreneurship and give us what we hope to be a sourcing advantage.

Clients can gain exposure to early-stage investments through our Private Equity Partners (PEP) vehicles. These are concentrated portfolios of high-conviction ideas, incuding venture capital. We invest in a few managers every year, leveraging our firm's research and contacts to make long-term strategic allocations.

SUPERIOR SIX

PEP I and PEP II are ranked in the top quartile among peer portfolios. PEP III held its final closing in 2015, focusing on six managers geared to outperform regardless of the market cycle. We recently launched PEP IV and are lining up investments with what we believe are some of the strongest venture capital managers today. The portfolio will also focus on buyout and growth equity investments, which we believe will complement venture capital on a risk/return basis.

Through the PEP model, we have invested in several early-stage standouts. We partnered with Lux Ventures, which focuses on hard sciences, nanotechnology, robotics and other areas off the beaten path of venture capital. In August 2012, Lux backed Auris Surgical, a nano-surgery company started by Fred Moll, the founder of Intuitive Surgical and creator of the da Vinci® robot. Lux invested $4.6 million in Auris at a $7.5 million pre-money valuation. In September 2015, Auris raised $150 million at a $472 million valuation, generating a 50-fold surge in the valuation in just three years.

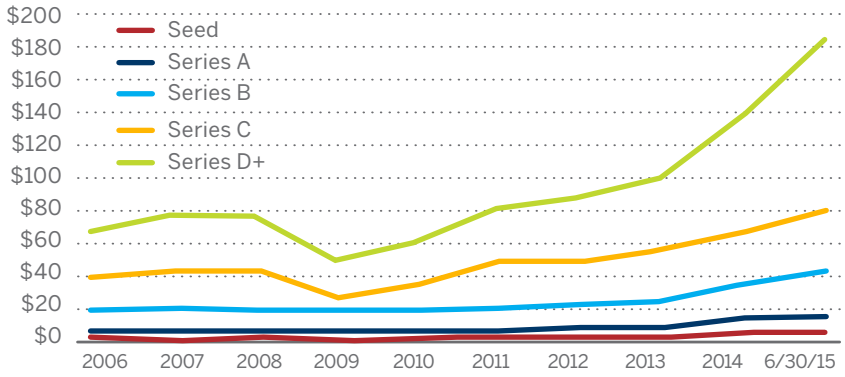
We hitched a ride on Cyvera's ascent by partnering with Blumberg Capital, an early-stage venture capital firm investing in emerging companies in Europe and Israel. Cyvera's beta tests backed up its marketing pitch that its software was especially potent in averting zero-day attacks, or hacking that occurs before the vendor makes any attempt to fix a software vulnerability. Palo Alto Networks snapped up the company to stay competitive in the increasingly complex field of cybersecurity.

Other investors can chase unicorns. We believe there is more money to be made riding early-stage opportunities like Cyvera.

Fledglings First

We believe early-stage investments offer the best opportunity for value generation as companies remain private longer. During the past decade, late-stage venture valuations have skyrocketed while their early-stage counterparts have remained steady.

MEDIAN VALUATIONS BY FUNDING ROUND IN EARLY-STAGE AND LATE-STAGE VENTURE CAPITAL
IN $MILLIONS (1/1/2006-6/30/2015)



SOURCE: PITCHBOOK DATA, INC.

Back in Fashion: The Jackie Onassis Trust

Jacqueline Kennedy Onassis structured her will with an approach toward charity and her heirs that, given the outlook for interest rates, is back in style.

Through her will, former first lady Jacqueline Kennedy Onassis left behind a sizeable inheritance for her children while incorporating an innovative estate planning tool aimed at meeting her philanthropic goals. Mrs. Kennedy's will included a little known technique at the time—called a Charitable Lead Trust (CLT)—to provide a long-term benefit to charity and her family, while minimizing her estate tax liability. Best employed while interest rates are low, the CLT is even more attractive today than when Mrs. Kennedy's plan was conceived.

A CLT is known as a "split-interest trust" because it provides a stream of cash flow for one set of charitable beneficiaries for a fixed term, with the remainder going to a second set of beneficiaries, usually family members. It can be established during one's lifetime or at death, with a goal of minimizing gift or estate tax. For example, a donor could establish a CLT today for a 10-year term. During the period, the CLT would pay an annual annuity to a charity. At the end of the 10 years, any assets remaining in the trust would pass to the donor's heirs.

PHOTO:RDA/GETTY IMAGES

Several wealthy families have used CLTs, including the heirs of Sam Walton, founder of Wal-Mart. They have deployed the structure to transfer more than $9 billion with minimum taxation. The Waltons are not alone. U.S. families in 2012 held nearly $24 billion in CLTs, according to IRS data.

The CLT provides significant wealth transfer and charitable benefits for someone whose wealth will probably exceed the gift and estate tax exemption, set at $5.45 million for 2016. First, the IRS determines the present value of a trust by adding together the stream of scheduled payments to charity and the income from a threshold interest rate set every month by the IRS and locked in when the CLT is created. (The rate for March is 1.8%.) If the trust's assets are invested for growth and appreciate beyond the threshold rate, then there will be trust assets remaining at the end of the term that will pass to family members without any transfer taxes. That can result in meaningful savings. Today, after the gift and estate tax exemption is exhausted, federal transfer tax rates are 40%.

NO DRAG

Another benefit accrues based on the income tax efficiency of a CLT. It is a taxable trust but, if structured as its own tax-paying entity as a non-grantor trust, it receives a charitable income tax deduction based on the annual payment to charity. This deduction is not limited by the level of adjusted gross income, as it can be for individuals. Instead, it is a dollar-for-dollar deduction that often will allow the trust to operate with no tax liabilities. Without a "tax drag" on the trust portfolio, the assets stay invested and grow for the benefit of family beneficiaries. While an individual who makes similarly sized gifts to charity over time will also benefit from the tax deduction, the difference between an allocation for tax paid compared with no tax paid can total as much as 0.5 percentage point per year in after-tax annualized returns. Over time, that difference can add meaningful value to the remainder gift.

The CLT is most effective when two factors are aligned: the IRS threshold interest rate is low, and growth of the assets in the trust is high. The IRS threshold growth rate generally correlates with

BY CRAIG STANDISH
Strategic Advisor

SUSAN MILONA
Strategic Advisor

Trend-Setting Trust

A Charitable Lead Trust can generate more for both charity and heirs than conventional annual philanthropic giving. This example is based on the current 1.8% appreciation rate set by the IRS and an assumed 6% annual growth rate for the underlying assets.

	ANNUAL $1 MILLION GIFTS TO CHARITY FOR 10 YEARS	GIFT TO $10 MILLION, 10-YEAR CHARITABLE LEAD TRUST
Total to Charity Over 10 years	$10,000,000	$11,300,000
Total to Heirs	$0	$4,200,000
Pluses	• Amount can be adjusted up or down each year. • Donor can stop giving at any time.	• Leverages low interest rate to provide assets to heirs free of gift tax. • Growth in assets is allocated partly to the charity, increasing the total amount the charity receives.
Minuses	• Growth of assets not yet gifted increases the value of the donor's estate, thereby increasing estate tax. • No residual assets provided to heirs.	• Larger up-front commitment. • Risk that growth of assets does not exceed the IRS baseline rate, so no residual assets pass on to heirs.

SOURCE: BROWN ADVISORY CALCULATIONS

yields on Treasury securities. So it is safe to assume that as interest rates rise, the IRS will also raise its threshold rate. With Federal Reserve policymakers forecasting as many as four increases in the benchmark interest rate this year, the benefits of a CLT may begin to wane over time. The current IRS rate, while nearly double the 1% level in 2012, is far below the 10% of the early 1990s. Delaying establishment of a CLT may mean lost opportunity. While the White House and some lawmakers have called for closing the CLT's gift-tax "loophole," such efforts have yet to gain traction in Congress.

CROSSING THE THRESHOLD

In terms of investments, careful thought must go into the selection of assets to transfer to the CLT. Naturally, a donor wants to invest in assets that will grow at a rate higher than the IRS threshold. But to maximize the gift tax benefit, the donor wants to dramatically outperform the IRS rate. Thoughtful research and careful selection of assets can therefore boost the trust's prospects for success.

Using a CLT has clear advantages compared with the usual approach of annual charitable giving. Consider the above chart, which compares making annual charitable gifts of $1 million during a 10-year period with creating a $10 million CLT terminating after 10 years with the current 1.8% threshold appreciation rate set by the IRS and an assumed 6% annual growth in assets.

Mrs. Kennedy's CLT was designed to begin at her death and last for 24 years, with the amount remaining at the termination of the trust passing on to her family. She aimed to save her estate millions of dollars in federal estate tax, boosting the amount provided to charity and her family. However, she gave her children the option to forgo the CLT and its tax advantages and obtain their inheritance outright, without delay. Unfortunately, they chose that option, and Mrs. Kennedy's thoughtfully planned CLT never came into existence.

A CLT as envisioned by Mrs. Kennedy remains a powerful tool for philanthropic giving and for providing for heirs, especially with today's historically low interest rates. Its potential benefits show that innovative estate planning never goes out of style.

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The S&P 500 Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include: market capitalization, financial viability, liquidity, public float, sector representation, and corporate structure. An index constituent must also be considered a U.S. company.

The Barclays Mortgage-backed Securities Index is a market value-weighted index which covers the mortgage-backed securities component of the Barclays U.S. Aggregate Bond Index. The index is composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income.

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