Brown ADVISORY
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The Advisory

INVESTMENT OUTLOOK FOR PRIVATE CLIENTS

SEPTEMBER 2016

DEFENSE, OFFENSE

Amid rising economic and political risk worldwide, investors need to shield against volatility while staying alert for new opportunities.

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At The Ready

Rising political and economic risk during the past year has widened the range of possible positive and negative scenarios for financial markets. Consequently, investors need to build a solid defensive position while seizing opportunities that arise amid the instability.

Shield or sword? More so than any other time since the financial crisis we believe that a winning investment portfolio today needs a thoughtful focus on both.

As rising economic and political risk fuels market volatility worldwide, investors need to maintain adequate liquidity, stability and diversification to shield against any protracted economic downturn. At the same time, they should be alert to the investment opportunities that emerge amid turbulence, knowing that companies create value, and innovation and entrepreneurship generate wealth, even amid severe instability.

The causes for uncertainty are numerous: aggression by ISIS, weakening global growth, concerns the European Union will unravel, declining productivity, stagnant real incomes and an increasing public hostility toward globalization, or the free flow of capital, goods and people worldwide. Additionally, political uncertainty has increased with rising nativism and protectionism, and the reassertion of national borders in countries including the U.S., U.K., France and Germany. Policy built on these ideas threatens growth, and could gradually erode the economic and political underpinnings for post-World War II prosperity.

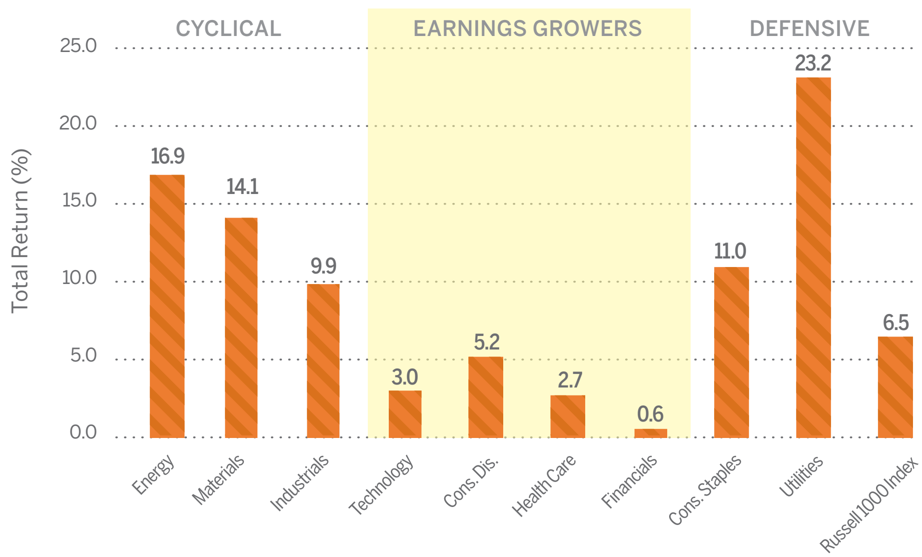
As a result, our evaluation of possible scenarios suggests that the range of positive and negative outcomes has widened during the past year. Although our analysis may sound dour, we see plenty of reason to believe that over the long term, investment markets can still generate returns for investors.

Innovation and dynamism are alive and well despite several years of low economic growth. There have been tremendous

Sidelined Leaders

Shares in technology, health care and other sectors commonly associated with strong earnings growth have lagged this year as investors snapped up defensive, dividend-oriented stocks, and rising commodity prices buoyed cyclical companies such as energy.

TOTAL RETURN, RUSSELL 1000® INDEX SECTORS
(AS OF 07/31/2016)



SOURCE: BLOOMBERG

BY TAYLOR GRAFF
Head of Asset Allocation Research

ED CHADWYCK-HEALEY
Head of International Private Clients

advances in worldwide communications, medicine and computing power, and some promising recent indicators such as gains in U.S. consumption, wages, equities and housing prices. History has shown that stock markets can still produce returns during periods of economic and political turmoil such as the 1940s and 1970s.

Looking ahead, for our base-case scenario we see inflation remaining moderate and most major economies continuing to grow at a modest pace. Still, with short-term volatility likely to persist, we recommend that investors build a solid defensive position through:

An ample liquidity bucket. Given the potential catalysts for an adverse period, we believe investors should maintain and regularly replenish a pool of cash to cover immediate expenses. An adequate operating account helps to ensure that an investor will not need to make ill-timed sales of securities to meet routine outlays during times of severe volatility such as the aftermath of the U.K. vote in June to leave the European Union.

High-quality, intermediate-duration bonds. These securities provide diversification from equities and yield substantially more than cash. Over the medium term, intermediate-duration bonds are relatively insulated from losses, even with interest rates historically low in the U.S. and U.K. An investor can take advantage of this low-return, low-risk option by "rolling down" a sloping yield curve. For example, an investor can purchase a highly rated 10-year bond and hold it for three years, gaining price appreciation as the security effectively becomes a seven-year bond. This provides a meaningful boost to return in a low-yield environment and cushions a portfolio should interest rates begin to rise. (We foresee a limited risk of interest rates moving significantly higher from current levels.)

These two steps would help investors in the event of an adverse outcome. After building a bulwark against risk, investors can confidently consider going on the offensive—selectively seizing opportunities that arise amid the instability through purchases of:

Stocks with potential for earnings acceleration. In reaction to volatility and low yields, investors this year have pushed up the prices of defensive, low-growth, dividend-oriented stocks in consumer staples, utilities and telecommunications. In addition, rising commodity prices have buoyed shares in cyclical sectors such as energy, materials and industrials. Meanwhile, sectors known for their potential earnings growth have lagged, as shown by the chart on page 2. We are looking very carefully for opportunities in this growth arena, which includes technology, financials, health care and consumer discretionary stocks.

The boom in cloud computing, which has driven the share prices of Amazon, Microsoft and Google in recent years, underscores the abiding value of innovation. Maintaining liquidity allows a portfolio manager to snap up new opportunities such as General Dynamics, whose shares have risen 14% this year as of September 6. (Please see the article on page 6.)

U.S. small-cap stocks. Compared with large caps, small-cap companies generally sell at a lower price-to-sales ratio (1.1 versus 1.9 as of July 31) and generate profit margins with a greater upside potential. Because of their more domestic focus, U.S. small caps face milder headwinds from a strong dollar and from any weakness in China or the global expansion. They would also be less vulnerable to a decline in Europe's post-Brexit vitality in our view.

High-yield bonds. The spread between the yield on benchmark Treasuries and high-yield bonds remains above the historic average even after narrowing on the recovery in commodity prices that began in mid-February. Such bonds perform comparatively well during periods of low growth and low inflation because companies often operate at a pace that is sufficient for repaying debt but below a level that would prompt an increase in interest rates. High-yield bonds are especially attractive compared with developed-market stocks, which currently sell at valuations above the historical average and face headwinds to profitability from slowing global growth and rising labor costs.

The performance of high-yield bonds during the past two years underscores how periods of turmoil open up opportunities for sizable gains. During the boom in U.S. shale oil production early this decade, energy companies found ample demand for high-yield debt among investors who believed oil would remain above $100 per barrel. The value of energy-related bonds grew to 20% of the high-yield market.

As the price of oil began to drop in 2014, investors in high-yield credit grew increasingly concerned about default risk among energy companies. Market jitters increased in mid-2015 amid signs that growth was slowing in large economies—most significantly, China. (From June 2014 until February 2016, the oil price plunged 75%.)

Our analysis showed that default rates were unlikely to rise significantly among issuers of high-yield debt with no involvement in energy. So when the high-yield market declined in September 2015 and February 2016, we stepped up allocations to such credit. This year through July 31, high-yield bonds as measured by the Barclays High Yield Index rose 12%, a meaningful gain on a risk/return basis compared with the 7.7% return for the Standard & Poor's 500 Index. (Please see the table below.)

While building a buffer against volatility, investors should remember that stocks have generated sizable long-term gains even during the most tumultuous decades. During the 1940s—despite a global depression, world war and the start of the U.S.-Soviet nuclear arms race and Cold War—the S&P 500 Index rose at an average annual rate of about 9%. During the 1970s—despite a toxic mix of low growth and inflation, a more than ninefold surge in the price of oil and a political crisis that culminated in the first resignation by a U.S. president—the S&P 500 Index increased at an annual average pace of about 6%.

This decade poses its own distinct set of economic challenges, many of which are aftershocks from the 2008—2009 financial crisis. Declining productivity among advanced economies has weakened global growth. U.S. productivity during the second quarter fell at a 0.5% seasonally adjusted rate, according to the Labor Department. It was the third consecutive declining quarter and the longest negative streak since 1979.

> "CURRENT HEADWINDS WILL PROBABLY NOT HALT ECONOMIC GROWTH."

Central bank stimulus—including record-low interest rates and unprecedented large-scale bond buying by the Federal Reserve, Bank of Japan and European Central Bank—has failed to kindle rapid economic growth while posing new risks given the unconventional nature of some of these efforts such as negative interest rates.

Still, there are certain signs of strength that suggest that current headwinds will probably not halt economic growth. Business creation and innovation are strong. Applications to the U.S. Patent and Trademark Office nearly doubled from 2000 until 2015 to 630,000. Also, market economies since the implosion of mortgage finance last decade have shown resilience and renewed dynamism, with the U.S. economy alone creating 14 million jobs.

No matter how dire or shrill the media's message may become, we will remain committed to helping our clients find the right balance between risk and opportunity, and focus on their long-term goals.

Lower Risk, Higher Return

The total return of high-yield bonds this year has outpaced the gain of the Standard & Poor's 500® Index as of July 31.

TOTAL RETURNS (as of 7/31/2016)	3-MONTH RETURN	YTD RETURN	3-YEAR RETURN (Annualized)
Large-Cap U.S. Equities S&P 500® Index	5.8%	7.7%	11.1%
Small-Cap U.S. Equities Russell 2000® Index	8.3%	8.3%	6.7%
Developed Int'l. Equities MSCI EAFE® Index	0.6%	0.4%	2.0%
Emerging-Markets Equities MSCI Emerging Markets® Index	5.2%	11.8%	-0.3%
Inv.-Grade Fixed Income Barclays Aggregate Bond Index	2.5%	6.0%	4.2%
High-Yield Fixed Income Barclays High Yield Index	4.3%	12.0%	4.5%
Commodities Bloomberg Commodity Index	-1.4%	7.3%	-12.6%

SOURCE: BLOOMBERG

Hungering For Yield

Investors snapping up U.S. securities are seeking yield as much as safety.

BY TOM GRAFF, CFA
Head of Fixed Income

LYN WHITE, CFA
Credit Analyst

The rush by investors had all the hallmarks of a bond market panic. When the U.K. voted on June 23 to leave the European Union, yields on the benchmark 10-year Treasury note plunged to a record low of 1.32%.

Yet fear that the EU will unravel was not the only impulse driving investors. Opportunism also fueled much of the buying—the yield on investment-grade corporate bonds fell more than the yield for Treasuries.

Investors today hunger for yield as interest rates worldwide sink toward or below zero. Their craving has belied longstanding predictions that the end to the 30-year bull market in fixed-income securities is imminent. In fact, investment-grade bonds rose 5.9% during the year ended July 31, according to the Barclays Aggregate Bond Index, outperforming other major asset classes including equities in both developed nations and emerging markets. Given that this trend is both unpredictable and unprecedented, we are maintaining our focus on buying bonds through a bottom-up analysis of each security rather than on a top-down forecast on the direction of interest rates.

Recent history suggests that interest rates should not be so low. The outlook for the U.S. economy is brighter today than in 2009, when 10-year Treasuries hovered around 3.2%. Unlike in 2011—2012, Greece is not on the verge of default and a handful of European countries do not require bailouts. Moreover, the Federal Reserve is not artificially pushing down interest rates by purchasing securities. The central bank bought $4.5 trillion in assets from 2008 until 2014 in an effort to spur borrowing and revive growth.

Since the end of the Fed's so-called quantitative easing, however, weakening global demand has prompted a steady slide in interest rates, with some yields in Japan and continental Europe falling below zero. The start of bond purchase programs by the Bank of Japan, European Central Bank and Bank of England (BOE) has reinforced the decline.

The BOE in August, attempting to avert a post-Brexit recession, announced a cut to its main interest rate and plans to buy corporate and government bonds. BOE policymakers expect to reduce the rate again later this year. Capital flows since the Brexit vote have highlighted that the U.S. offers one of the only large, liquid bond markets with positive yields spanning a variety of maturities and credit qualities.

With the outlook for interest rates so cloudy, we have outperformed by concentrating on the characteristics of individual bonds. We look for corporate, municipal or securitized debt with mispriced risk—allowing us to gain when the price corrects. Here are some examples:

In March, we bought bonds issued by Campbell Soup, a 146-year-old company with solid cash flow but limited avenues for growth. Campbell bonds had declined excessively amid weakness in the corporate bond market. Investors had also overestimated its credit risk. We would have been satisfied to simply earn its 2.8% yield, but when the credit premium for Campbell bonds fell, along with general interest rates, we generated a solid gain.

So too was the case with Micron Technology, one of the three top producers of memory semiconductors used in servers, tablets and smartphones. We purchased Micron bonds in June 2016, confident that investors had overestimated its default risk because of expectations that excessive supply would keep down the price of semiconductors for an extended period. In our view, Micron holds enough liquidity and generates sufficient free cash flow to weather the cyclical slump. Once the oversupply dries up, we believe our Micron debt will perform especially well.

The mispricing of default risk can provide opportunity regardless of whether the company in question makes chicken noodle soup or the neural network for advanced electronics. Especially in times when predicting the direction for interest rates is particularly ill-advised, there is steady income and upside potential to be made in bonds with unappreciated potential.

On Target

Geopolitical instability and the end to nearly a decade of budget austerity have improved the prospect for defense industry stocks.

Forget the Machiavellian notion that the best defense is a strong offense. Amid persistent instability in geopolitics and global finance, an investor in equities can both limit risk and find opportunity with a targeted stake in the defense industry.

An investment in defense contractors—which tend to perform independently of economic growth—provides diversification that could help buffer a portfolio against setbacks from a slowing global expansion. Demand in the sector is robust, with several governments boosting defense spending in response to terrorism, tension or outright conflict in East Asia, the Middle East and Ukraine, and the increasing sophistication of weapons produced by Russia and China.

"Western military technological superiority, a core assumption of the past two decades, is eroding," according to John Chipman, chief executive of the International Institute for Strategic Studies (IISS). Most notably, Russia and China are challenging Western democracies with advances in ballistic and cruise missiles, combat aircraft, air defense systems and armored vehicles, according to London-based IISS, a think tank focused on global security and military conflict.

To be sure, some investors may not want to own defense companies and the industry is not without risks. Although stock prices for arms makers tend to rise during an election year as candidates talk up national security, such jawboning does not prevent post-election cutbacks in defense in response to public pressure for austerity. Low oil prices may also inhibit demand from some of the world's biggest arms importers such as Saudi Arabia. Moreover, low correlation with the economy means that defense industry stocks would probably lag other industries during a boom. In our view, though, these risks will not meaningfully halt the industry's tailwinds:

Regional tensions. China, North Korea, Russia and Iran show no signs of scaling back ambitions to build their regional clout. Despite a recession, Russia expanded defense spending last year at a faster rate than any other major military power. Its $65.6 billion budget for 2015 equaled roughly 5% of gross domestic product, according to IISS. From 2009 until 2015, China annually boosted its defense budget by $10 billion to $15 billion, spending $146 billion last year.

Rearming democracies. In response, the U.S., Europe and major weapons importers, including India, Japan and South Korea, are stepping up spending. For fiscal year 2016, the U.S. increased its defense budget for the first time in eight years. The Pentagon, which accounts for more than 80% of arms makers' revenue, plans to boost its discretionary budget authority by 4.4% to $585.2 billion in fiscal year 2021, from $560.4 billion in fiscal year 2015. Many European countries have restored military outlays on a growth trajectory, while Japan and South Korea have announced plans to buy several squadrons of F-35 jet fighters.

"I can't think of a time when our international pipeline of opportunities was more robust than it is today," according to Tom Kennedy, CEO of Raytheon, maker of torpedoes, laser-guided bombs and the Patriot missile defense system. International sales during the second quarter surged 8%, Kennedy said in a July 28 conference call with analysts.

Steady spending. Growth in defense spending is comparatively transparent and predictable—in the U.S., post-World War II cycles have lasted as long as nine years. The Pentagon also breaks down its budget into line items, enabling multiyear projections of revenue growth for companies focused on specific weapons programs.

Arms makers on average offer a 1.75% dividend and free cash flow yield of 6.5%, which exceeds the amount for most other industrial companies, including the free cash flow yield of 5% at 3M and 5.2% at Danaher. Among major defense contractors, **General Dynamics** leads the pack with a dividend yield of 2% and a free cash flow yield of 7% for fiscal year 2017.

BY ADI PADVA
Equity Research Analyst

General Dynamics is benefiting from stepped up funding for the construction of U.S. destroyers and Virginia-class nuclear-powered attack submarines. It is also developing a replacement for Ohio-class ballistic missile submarines, which were first commissioned in 1981. An order backlog totaling 19,000 for the company's combat vehicles—including the eight-wheel Stryker and the Abrams battle tank—is equivalent to 3.4 times annual production as of December.

General Dynamics sells at a price-to-earnings ratio of 15, which is meaningfully lower than the average of its rivals focused only on defense: 18. The discount stems largely from investor pessimism over the company's Gulfstream jet business. Orders for business jets from corporations and affluent individuals have declined in recent years, largely because of weakness in emerging markets, especially Russia and China, where demand had been strong. Orders waned partly because of an anti-corruption campaign in China and financial sanctions against individuals allegedly backing efforts to destabilize Ukraine.

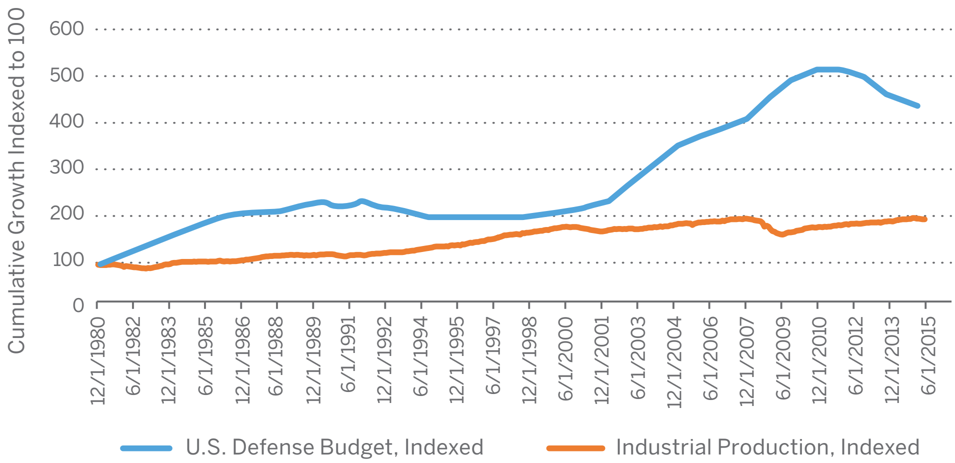
We believe the decline in demand for the company's large-cabin business jets—widely deemed to be the top in the industry—will probably be shorter than most investors anticipate. Indeed, we are hoping that shares of General Dynamics will rise as the company rolls out two new models of high-end jets and continues to gain market share. A two-year backlog for the Gulfstream G-650, the company's flagship aircraft pictured on page 6, also mitigates some of the downside risk.

In a time of persistent geopolitical tensions, we believe that defense industry stocks offer the prospect for meaningful gains and a countercyclical buffer against weakening global economic growth.

Different Drumbeat

Shares in the defense industry offer an opportunity for portfolio diversification, with the Pentagon's budget and U.S. industrial production moving independently during the past 35 years.

COMPARISON OF U.S. DEFENSE BUDGET WITH INDUSTRIAL PRODUCTION
(12/01/1980—06/01/2015)



SOURCE: BLOOMBERG

Sweet Spot

Private credit can offer earlier distributions than private equity and higher yields than most publicly traded securities.

Sometimes it pays for investors to find sources of income outside the conventional public channels for fixed income securities. Take private credit, for example. With interest rates at record lows and many publicly traded bonds and stocks approaching historically high valuations, private credit has become increasingly attractive to investors because of its total return prospects, steady income and role in diversification.

Geared to middle-market companies, private credit encompasses direct lending, mezzanine finance and distressed debt. It also typically features stricter covenants and larger collateral than many other fixed income securities issued on public markets. Historically, investors have been compensated for private credit's relative illiquidity with income that has exceeded the yields on levered bank loans or high-yield bonds by about 2 to 4 percentage points.

The market for private credit is a growing alternative to traditional fixed income. The supply of capital is high, with private debt fund managers holding a record $199 billion available for private credit as of June 30, 2016, a 173% surge from $72.9 billion in 2006, according to Preqin. This has been driven by steady growth in private debt fundraising during the past 10 years.

Demand is also robust. The current wave of private credit resurgence sprung from the 2008—2009 financial crisis as the banking industry retreated from many kinds of traditional lending after the enactment of stricter regulation under the Dodd-Frank Act and the global banking accord known as Basel III. Companies with EBITDA ranging from $50 million to $100 million found difficulty obtaining financing from conventional lenders, so they turned to hedge funds and other nontraditional sources of "shadow banking."

The comparatively high yields of private credit gain luster during periods of unusual volatility in public bond markets such as today. Sellers of private credit offer a "one-stop shop" for buy-and-hold fixed income investments, compared with the uncertainty of pricing and demand in the publicly syndicated markets.

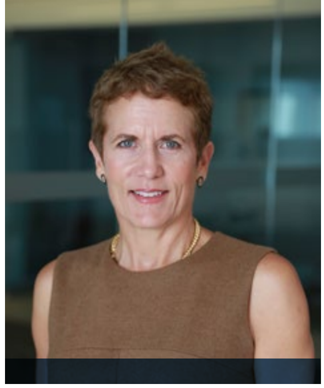
For an investor*, private credit can help diversify a portfolio while complementing other fixed income components such as investment-grade and high-yield bonds. In addition, unlike private equity, private credit can generate income almost immediately. Investors can soon begin receiving income based on current cash yield and up-front fees, which are loan origination fees paid by the borrower. In contrast, the distributed returns on conventional private equity usually kick in after several years, tracing what is known as a "J-curve."

> "HISTORICALLY, INCOME FROM PRIVATE CREDIT HAS EXCEEDED THE YIELDS ON LEVERED BANK LOANS OR HIGH-YIELD BONDS BY APPROXIMATELY 2 TO 4 PERCENTAGE POINTS."

Moreover, private credit offers opportunities for additional returns, including through prepayment penalties and payable-in-kind interest, a non-cash periodic payment that increases the principal amount of the security based on the amount of the interest. In some cases, investors can also gain equity ownership.

Still, private credit is not without potential downsides, including default risk. The earnings of small businesses can be volatile, posing the possibility of late payment or unpaid debts. Also, private credit is often structured as a long-term investment with lock-ups ranging from five to 10 years. Moreover, while posing less risk than private equity, private credit is likely to provide a lower return.

* Private credit may be only available to Qualified Purchasers and/or Accredited Investors.



BY MEERA PATEL, CFA
Director of Private Investment Research

JANE KORHONEN, CFA
Portfolio Manager

Nevertheless, with careful attention to risk, we believe that private credit can serve within a balanced portfolio as a high-yielding complement to conventional equity and fixed income securities. We encourage clients to view private credit as an opportunistic asset with low liquidity offering steady growth.

To achieve an optimal risk/return balance, we have invested in asset managers that have performed comparatively well in a variety of credit conditions:

Crescent Capital Group. Crescent Mezzanine is a U.S. middle- and upper-middle market mezzanine debt investor focused on companies with EBITDA ranging from about $50 million to $150 million. The companies are backed by private equity sponsors. Since 1992, Crescent Mezzanine's seven pools of capital have invested approximately $10.7 billion in 183 mezzanine investments. The funds have generated a 13.8% net internal rate of return (IRR)* with a cumulative annual default rate of less than 1%. We recently invested in Crescent Mezzanine Partners VII, a 2016 vintage fund. (Mezzanine debt is the middle layer in a company's capital structure that is junior to secured senior debt and senior to equity.)

Yukon Partners. Founded in 2008, Yukon Partners is a U.S. mezzanine investor focused on companies with EBITDA ranging from about $10 million to $30 million and backed by private equity sponsors. Yukon targets 85% of its portfolio to mezzanine capital and 15% to equity-related structures. We invested in Yukon Capital Partners II, a 2014 vintage fund.

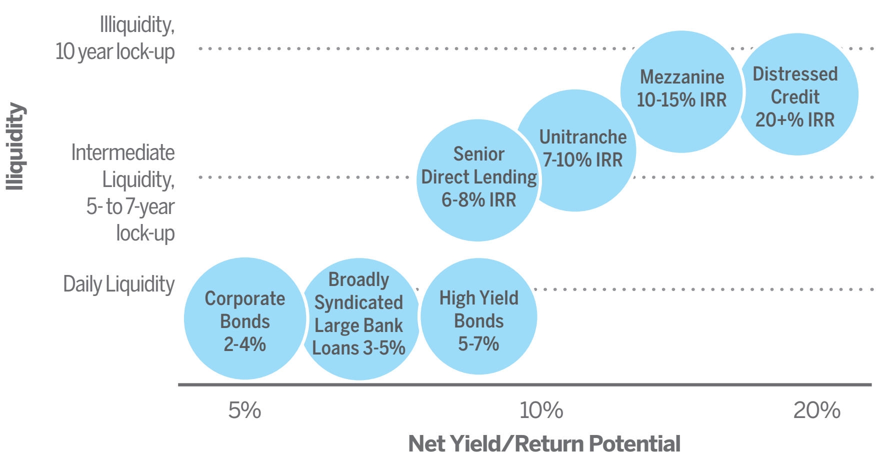
Private credit can supplement a traditional portfolio of stocks and bonds with expected current cash flow and potential returns similar to equities. It occupies a preferred position in an issuer's capital structure and thereby offers a foothold against risk in a time of high valuations and financial market instability. *B*

Less Liquid, Higher Return

Private credit—ranging from senior direct lending to distressed credit—offers a higher potential return than publicly traded fixed income securities while requiring a longer lock-up period.

* IRR is the aggregate, compound annual internal rate of return on an investment based on partnership inflows and outflows and the estimated value of unrealized investments at a specific date. Net IRR accounts for management fees and other fees—including expenses and carried interest—owed to the partnership manager. IRR is calculated as of June 30, 2016. Please see page 12 for additional information.

COMPARATIVE RISK/RETURN OF PRIVATE CREDIT



SOURCE: BROWN ADVISORY. The disclosure for alternative investments is available at: http://www.brownadvisory.com/en/alternativeinvestmentdisclosures

Shaping a Legacy

Multi-generational planning, while best executed in prudent steps over long periods, sometimes requires a review because of changes in regulation or financial markets. Such is the case today amid consideration of changes to U.S. tax law.

A plan to maximize a family's financial legacy usually saves the most tax by leveraging the long-term compounding of investments outside of the taxable estate. Adopting a program of planning early, and monitoring that program, often brings the best results. But saving tax is not the only objective—clients also need to know that their financial security is assured and that the long-term stewardship of family assets will be wise.

Harmonizing these concerns is particularly critical during times like today, when a change in law speeds up the planning process. The U.S. Treasury Department recently issued proposed regulations that would virtually eliminate valuation discounts on the transfer of shares in family businesses and investment pools held in Family Limited Partnerships or Limited Liability Companies, collectively known as FLPs.

The regulations are open to public comment and subject to change, and will not be effective before December at the earliest. Still, the possible elimination of the discounts in just a few months highlights the need for families with substantial assets to revisit their estate plans now.

Of course this is not the first time that a change in the law has spurred action. We undertook productive planning in 2012 when it appeared that gift and estate tax exemptions were about to shrink. Many trusts funded that year have grown outside of the grantor's estate by 35% or more. During times like today, when looming deadlines accelerate the pace of decision-making, the fundamentals of prudent planning still apply:

Emphasize the key facts for the client's consideration. Multi-generational planning can involve technical transactions that bear little resemblance to a client's "real-world" experience. Explaining the technicalities is often only a modest help to clients. They need a practical understanding of what the proposed strategy will mean to them, and that varies from one client to the next.

As previously mentioned, gifts of interests in FLPs are a timely example. These entities provide centralized control and management of a pool of family assets. Many clients who have FLPs will soon be considering larger-than-usual gifts of FLP interests to take advantage of valuation discounts while they are still available.

To move forward, one client may need to understand her ability to borrow from the FLP if necessary. Another client may be interested in how the FLP can be used to engage her adult children in family finances. A client making gifts of a family business may be focused on the impact of succession planning. In each instance the planning process needs to emphasize the aspects of the transaction that are critical to the client. The same basic process and considerations apply to other irrevocable components of a multi-generational plan.

Build the plan over time. The best results are achieved with a long-term, persistent approach. This iterative process allows clients to build on past planning successes each year and take larger steps as their circumstances permit. Sometimes the best way to start is with annual cash gifts that are tax-free up to a current limit of $14,000 per individual. By making those gifts to trusts, and/or by transferring a share to a family entity like an FLP, clients can keep control or devise a plan for stewardship that meets their approval.

FLPs can also be particularly helpful early in the construction of a multi-generational plan. Interests in these entities can be transferred in many ways without disrupting the management of portfolios or control of the FLP. This ability to regularly transfer assets can enhance the long-term estate planning process even if valuation discounts go away.

We collaborate with our clients and their outside advisors to generate and assess planning ideas. Our ongoing investment dialogue with clients gives us insight into many aspects of their lives, including their business assets, cash flow needs and family dynamics. By listening to clients, we seek to marry our

BY EDWARD DUNN
Strategic Advisor

MORGAN FOLUS
Strategic Advisory Analyst

understanding of their goals with our knowledge of strategies that best fit their needs.

A recent conclusion of an estate tax audit marked the end of a 30-year planning process for a family we will call the Smiths. An FLP funded with $30 million in 2002 was a key element of their long-term planning process. Given low liquidity needs and a long time horizon, the assets were invested for long-term growth.

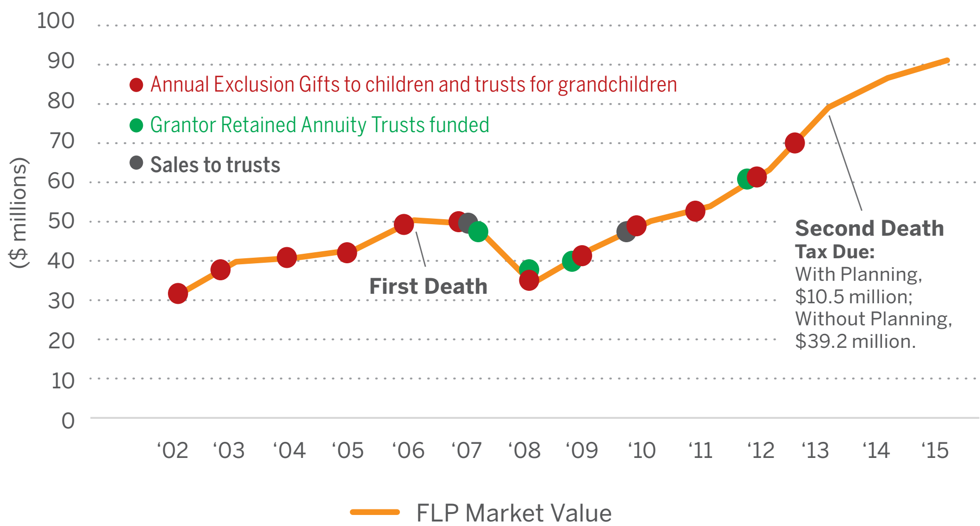
By the end of 2013, when the surviving spouse died, the value of the FLP had expanded 2.6 times to $78 million and was largely owned by trusts that were outside of the estate. By the end of 2015, the partnership value had risen to $90 million, or three times its original amount. The entire partnership—along with its future growth—is now permanently sheltered from estate and gift tax in long-term trusts. A total of $10.5 million in gift and estate taxes was paid in connection with this planning. Absent the planning, $39.2 million of federal and state estate taxes would have been due at the surviving spouse's death.

The savings for the Smiths illustrate the dramatic benefits that can be achieved through a thoughtful approach that avoids transactions made in haste and aligns closely with a family's goals for governance of their assets over the long term.

Tax Savings Toolbox

The Smith family saved $28.7 million in taxes by using the FLP to make annual tax-free gifts to trusts, fund Grantor Retained Annuity Trusts and sell assets to trusts.

SAVINGS FROM MULTI-GENERATIONAL PLANNING
(2002–2015)



SOURCE: BROWN ADVISORY. THE ABOVE ILLUSTRATION IS BASED ON THE EVOLUTION OF A FAMILY'S FLP FROM 2002 UNTIL 2015. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

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The cumulative annual default rate for Crescent refers to the amount invested of all mezzanine investments that experienced a payment default on the mezzanine securities divided by the total amount invested by the predecessor portfolio, Fund I, Fund II, Fund III, Fund IV, Fund V and Fund VI and further divided by the number of years since the first investment in the predecessor portfolio was made.

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