




**ATLANTIC TRUST**  
PRIVATE WEALTH MANAGEMENT

## Economic and Investment Overview

Fourth Quarter, 2009



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# Economic and Investment Overview

## Executive Summary

### Economy

- Recession over; third quarter GDP likely to show growth
- Lagged effects of stimulus programs leading to better economic tone
- Economic activity remains stronger outside the U.S.
- Inflation non-existent with slack in the system
- Recovery may be even more subdued than the mediocre expectations built into consensus forecasts
- Consumers face litany of challenges

### Policy

- Monetary: Fed to keep interest rates near zero for “extended time”
- Fiscal: aspects of the fiscal stimulus package may be extended
- Downward bias for the dollar
- Key issues: productivity and cost implications of expanded government role in economy

### Equities

- Q2 rally extended throughout Q3
- Rally reflects shift in multiples from very depressed levels to more normal relationships without much change in earnings expectations
- Increasing risk appetites have led to dramatic “dash for trash,” as lower quality investments have outperformed
- Positive profit comparisons expected in Q4 with 25% rebound in calendar 2010

### Bonds

- Clarity of the Fed’s message to keep rates low is an effort to improve sentiment and encourage investment
- Combination of low money market yields and improving investor attitudes is driving greater risk-taking in fixed income markets
- Corporations are extending their debt profile
- As balance sheets are bolstered and investor confidence improves, capital will flow toward credit risk rather than maturity risk

### Asset Allocation Themes

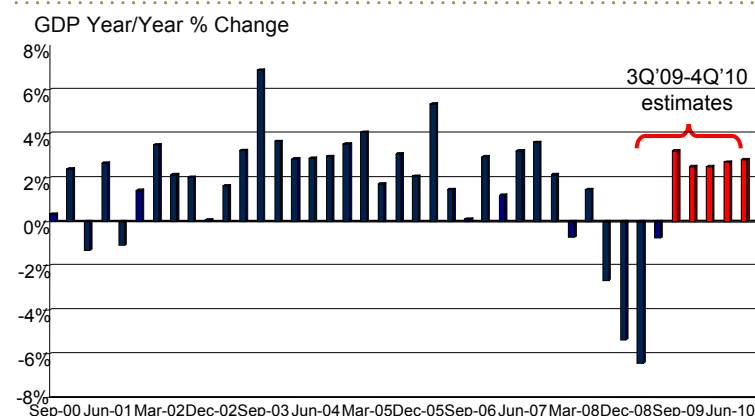
- Equity markets fairly valued; recommend gradual investment of cash
- High yield bond spreads tightened back into a normalized range; recommend suspending additional investment
- Attractive entry point for commodity exposure: reflation story and portfolio diversification
- Emerging market equities favored over developed markets: more growth, less debt burden
- Long/short hedged equity attractive: emphasis on stock-picking without full stock market risk
- Energy MLPs offer wide yield spreads over Treasuries and growing income streams

# Economic and Investment Overview

**Economics: “...economic activity has picked up following its severe downturn.” – Federal Reserve, 9/23/09**

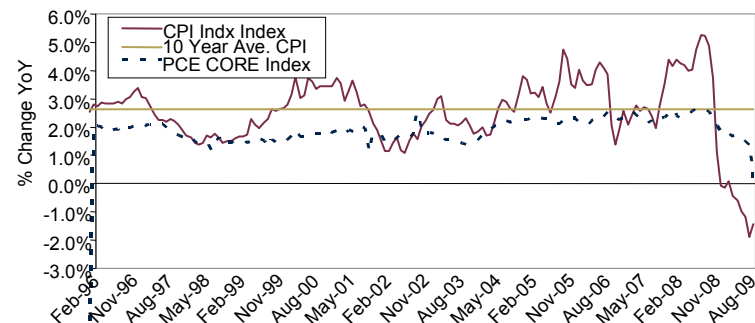
- Though not yet officially declared, the recession is likely over. After four quarters of decline in GDP, the third quarter will most likely show growth when reported in late October. The consensus forecast anticipates a subdued recovery through 2010.
- The recent better tone of economic news has been prompted by the lagged effects of monetary and fiscal stimulus. Very low interest rates and thawing of credit markets helped stabilize wounded sectors like housing and consumer spending. Very lean inventories have begun to be replenished, supporting our view of a short-term boost for the economy.
- Economic activity outside the U.S. has generally been stronger, especially in the emerging markets. Also, election results in Japan and Germany – the second and fourth largest economies, respectively – are likely to produce more pro-growth policies.
- Inflation is virtually non-existent. Indeed, the CPI is *down* 1.5% over the last year due to falling energy prices. The more stable “core” rate of inflation is up just 1.4%. A compelling case can be made for the inflationary consequences of explosive monetary growth, but this will only emerge later in the cycle. For the next several quarters, there will be too much slack capacity to allow for widespread price pressure.

## Positive GDP Growth Ahead



Source: Federal Reserve Data, Bloomberg, Atlantic Trust estimates

## Inflation Virtually Non-Existent



Source: Bureau of Labor Statistics, Bloomberg, data as of 8/31/09

# Economic and Investment Overview

## Economics: 2010 Growth Outlook – Consumer Headwinds Prevent Robust Recovery

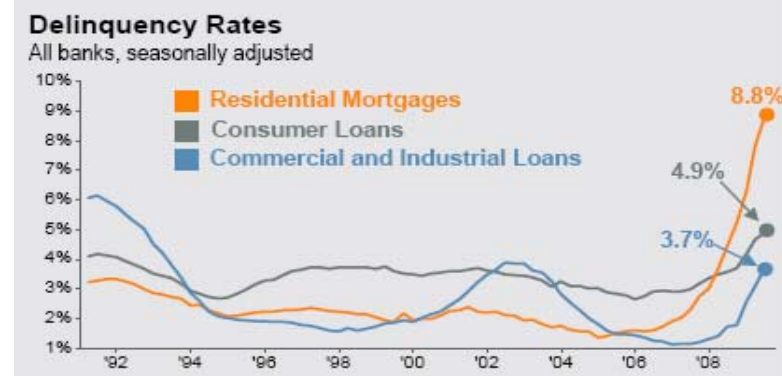
- We do not anticipate a “double-dip” back into recession. However, the recovery may be even more subdued than the mediocre expectations built into consensus forecasts. The single biggest reason is the weak state of the U.S. consumer. Consumer spending is 70% of total economy activity.
- Consumers face a litany of challenges that will only be resolved slowly:
  1. High unemployment
  2. High indebtedness and rising delinquency rates
  3. Deflated home values
  4. Lack of access to credit
- While residential markets show some signs of recovery, the commercial real estate market continues to soften and may create additional stress points on parts of the banking system in 2010.

### Unemployment Still a Tough Challenge



Source: Bureau of Labor Statistics, Bloomberg, data as of 8/31/09

### Consumer Delinquency Rates



Source: Federal Reserve, U.S. Treasury, J.P. Morgan. All data reflect most recently available releases. Delinquent loans are defined as 30 days or more past due. Data are as of 9/30/09.

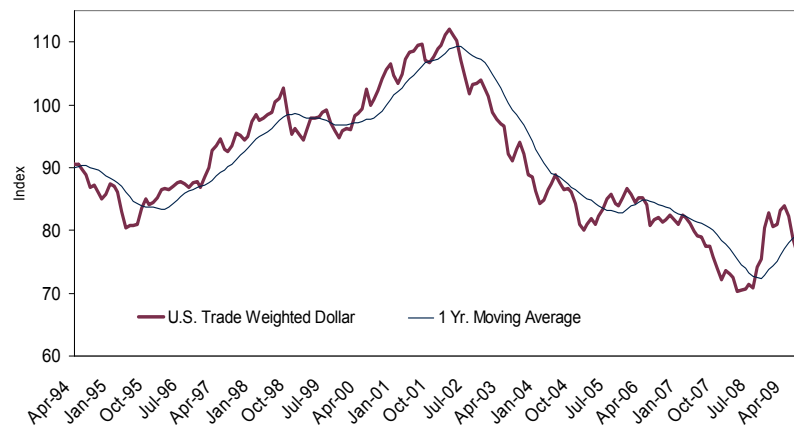
# Economic and Investment Overview

## Policy: Fundamentals and Politics Favor Easy Money and a Weak Dollar

- There are growing worries about two consequences of ultra-stimulative Fed and Treasury policies: exploding public debt and inflation. Nevertheless, the Fed plans to keep interest rates near zero for “an extended time,” and several aspects of the fiscal stimulus package may be extended. There is still great concern about the fragility of the recovery, especially as the 2010 congressional elections loom.
- The U.S. dollar has declined about 15% since the equity market recovery began in March. As risk appetites improved, money flowed out of the safe haven currency. The intermediate term bias for the dollar may continue to be down as relative growth and interest rates in the U.S. lag.
- The highly touted “Cash for Clunkers” program is an example of the pitfalls of government policy. After producing a surge in August vehicle sales, volumes plummeted in September after the program expired.

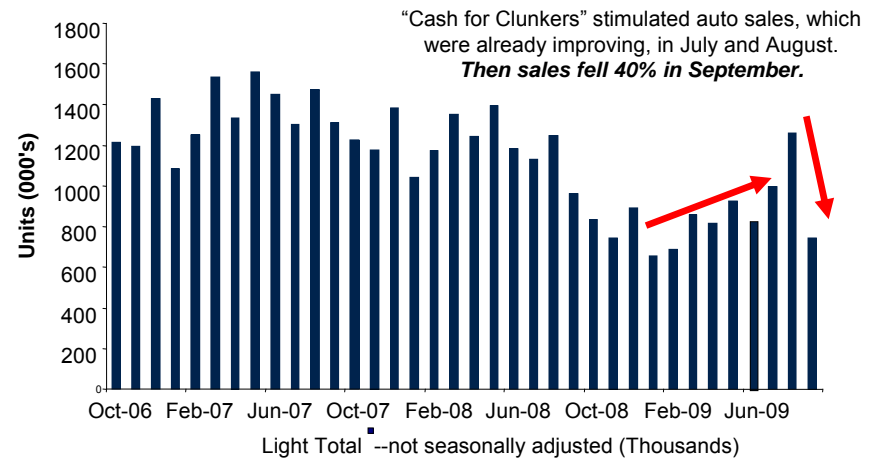
### Downward Bias for the Dollar

U.S. Trade-Weighted Dollar vs Major Currencies



Source: Federal Reserve, Bloomberg, data as of 9/30/09

### Vehicle Sales Pulled Forward?



Source: Bureau of Economic Analysis, data as of 9/30/09

# Economic and Investment Overview

## Domestic Equities: V-Shaped Rebound

- The year 2009 started out in a negative mode for equity investors, amidst a sharp deterioration in economic activity and weakening sentiment on the part of both consumers and businesses. Concerns were expressed that the economy was facing a “black hole” from which it might not emerge, and some pundits were making comparisons with the Great Depression of 1929-1933. Investors were very concerned about the risk of further deterioration in the value of their assets, and few wanted to buy anything other than essentially riskless investments.
- As a result, there was a final down leg in the bear market during January and February, reaching a low on March 9th. However, around that time, a run of better than expected economic reports started to suggest that activity was not accelerating on the downside, as some had feared. Indeed, some investors began to believe that the financial crisis would ease, that higher federal spending would substitute for weak business expenditures and that consumer confidence could actually improve.

- The mid-March inflection point was rather dramatic as stock prices moved steadily higher for the ensuing six months, producing a rally of more than 50% from the extreme low to the recent high. In fact, equities had their best advance in the third quarter compared to any similar period since 1998, with stocks showing a positive return for the first nine months of nearly 20%.

## Despite Rally, Still 30% Off of Market Highs



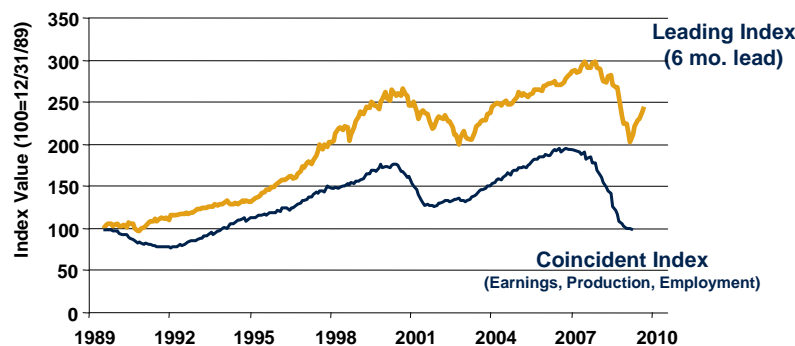
Source: Standard & Poor's, First Call, FactSet, J.P. Morgan

# Economic and Investment Overview

## Domestic Equities: Looking Ahead

- One of the problems in assessing the market today is that the recent rally has taken place based largely on expectations rather than actual improvement in the economy and corporate profits. Stated another way, it has reflected a shift in multiples from a very depressed level to a more normal relationship without much change in earnings expectations.
- Thus, to make further headway, we believe that conditions need to move from being “less negative” to being positive. As indicated earlier, economic activity continued to decline in the second quarter, although at a much slower rate than in the two previous quarters. It does appear, however, that growth is poised to resume in the second half of this year and continue in 2010.
- The best news is that based on the expected recovery in the economy and the cessation of asset write-downs, earnings should show a strong rebound next year. Based on our current forecast, we are estimating a 25% improvement in 2010 earnings for the S&P companies as compared to 2009.
- Since the market bottom in early March, we have had a powerful “low-quality” rally. Companies with specific characteristics have led the market: high volatility, low returns on equity, unprofitable and priced below \$5/share. This is unsustainable, and in a slow growth world, investors will rotate toward companies with durable earnings power and a global reach.

## Market Is Anticipating a Sharp Economic Recovery



Source: Bloomberg L.P., Standard & Poor's, Thomson Reuters, as of 9/30/09. Leading Indicators include S&P 500 Index and LEI. Coincident Indicators include Quarterly Operating Earnings, Industrial Production and Unemployment Rate (inversed).

## “Dash for Trash” Continues

S&P 500 Companies With Earnings vs Companies Without Earnings  
Relative Performance



Source: Factset, Thomson Reuters, weekly data through 9/30/09

# Economic and Investment Overview

## Non-U.S. Equities: Continue to Emphasize Foreign Holdings

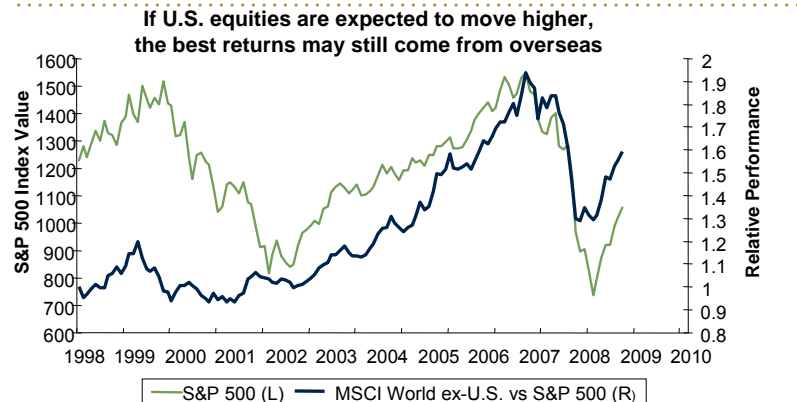
- Secular growth trends favor emerging markets versus developed countries worldwide. If the global economic recovery thesis stalls over the next several months, it would be reasonable to expect capital to flow back to highly liquid U.S. markets. Conversely, if the recovery plays out as we expect, it will continue to be led by emerging markets.
- While the large economies in Europe and Japan have been fading, there are early signs of improvement, and equity market valuations are somewhat cheaper than in the U.S. Furthermore, investing in euro- and yen-denominated securities provides a hedge against the downward trend of the U.S. dollar.
- The good news coming out of China earlier this year helped set the stage for the global market recovery. The Chinese government is now attempting to reduce credit availability in order to avert a real estate bubble while still allowing for the continuation of strong economic growth. This is a very tough needle to thread and represents a risk to the global recovery thesis.
- Most U.S. investors are under-represented in non-U.S. equities, which comprise a majority of global economic activity and corporate revenues. Recently, correlation between U.S. and foreign markets has decreased, largely a function of dollar fluctuations. This, along with an array of growth and value opportunities evident overseas and increasingly volatile currency markets, reinforces our belief that the diversification benefits of international exposure are strong.

### There Is Little Support for Under-Investing in Non-U.S. Equities

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	3Q09	YTD
MSCI Europe Ex-UK 34.0%	MSCI EME 66.4%	MSCI Europe Ex-UK -7.1%	MSCI EME -2.4%	MSCI EME -6.0%	MSCI EME 56.3%	MSCI EME 26.0%	MSCI EME 34.5%	MSCI Europe Ex-UK 36.4%	MSCI EME 39.8%	MSCI Japan -29.1%	Pacific Ex Japan 27.4%	MSCI EME 64.9%
S&P 500 28.6%	Pacific Ex Japan 64.7%	S&P 500 -9.1%	Pacific Ex Japan -3.8%	Pacific Ex Japan -8.3%	Pacific Ex Japan 47.0%	MSCI Europe Ex-UK 22.4%	MSCI Pacific Ex Japan 25.6%	Pacific Ex Japan 33.2%	Pacific Ex Japan 31.7%	S&P 500 -37.0%	MSCI Europe Ex-UK 25.1%	Pacific Ex Japan 64.5%
MSCI UK 17.8%	MSCI Japan 61.8%	MSCI UK -11.5%	S&P 500 -11.9%	MSCI Japan -10.1%	MSCI Europe Ex-UK 43.6%	MSCI UK 19.6%	Pacific Ex Japan 23.2%	MSCI Europe Ex-UK 17.5%	MSCI Europe Ex-UK 17.5%	MSCI Europe Ex-UK -45.0%	MSCI EME 21.0%	MSCI UK 34.0%
MSCI Japan 5.3%	S&P 500 21.0%	MSCI Japan -28.1%	MSCI UK -14.1%	MSCI UK -15.2%	MSCI Japan 36.2%	Pacific Ex Japan 17.7%	MSCI Europe Ex-UK 11.3%	MSCI UK 30.7%	MSCI UK 8.4%	MSCI UK -48.3%	MSCI UK 18.5%	MSCI Europe Ex-UK 31.8%
Pacific Ex Japan -7.8%	MSCI Europe Ex-UK 17.8%	MSCI EME -30.6%	MSCI Europe Ex-UK -22.0%	MSCI Europe Ex-UK -19.5%	MSCI UK 32.1%	MSCI Japan 16.0%	MSCI UK 7.4%	S&P 500 15.8%	S&P 500 5.5%	Pacific Ex Japan -50.0%	S&P 500 15.6%	S&P 500 19.3%
MSCI EME -25.3%	MSCI UK 12.5%	Pacific Ex Japan -35.2%	MSCI Japan -29.3%	S&P 500 -22.1%	S&P 500 28.7%	S&P 500 10.9%	S&P 500 4.9%	MSCI Japan 6.3%	MSCI Japan -4.1%	MSCI EME -53.2%	MSCI Japan 6.6%	MSCI Japan 9.4%

Source: MSCI Inc, Standard & Poor's, J.P. Morgan.  
 All data are reported in USD and represent total return including the reinvestment of dividends. Past results are not indicative of future returns. International investing involves a greater degree of risk and volatility. Changes in currency exchange rates and political and economic climate can raise or lower returns.

### Foreign Markets Leading the Way



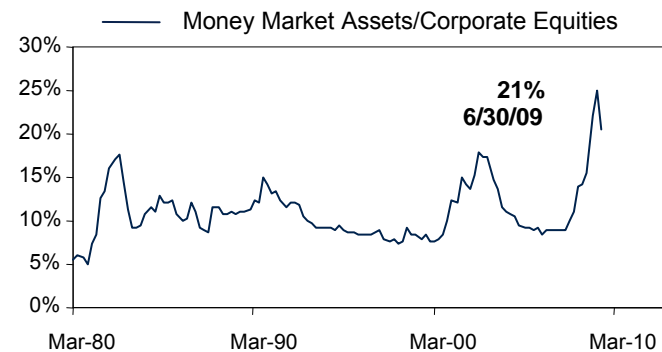
Source: Standard & Poor's, MSCI, 9/30/09

# Economic and Investment Overview

## Bonds: Too Much Cash, Not Enough Yield

- Since the Federal Reserve started easing monetary policy in late 2007, cash has represented an expanding portion of investor portfolios. Through both voluntary and involuntary actions, money market assets grew to over 25% of the value of corporate equities by the end of the first quarter.
- The Fed reiterated its stance toward exceptionally low rates for an extended period of time in the most recent FOMC meeting despite clear and broadening indications of health in the credit markets, growing optimism in equity prices and gradual improvement in a number of key economic indicators. The clarity of the Fed's message can be considered as another instrument of policy in the effort to improve sentiment and encourage investment.
- The current combination of low money market yields and improving investor attitudes is an unsustainable mix, and one that is helping to drive greater risk-taking in the fixed income arena. All yields are low on an *absolute* basis, but cash yields are as low *relative* to longer maturity bonds as they have been toward the end of recent recessions. The benefit of extension – swapping cash for longer maturity assets – appears very compelling for investors earning close to 0% as long as the Fed sticks to its current message. There is a delicate balance, however. Maturity extension often appears compelling when monetary policy is approaching an inflection point.

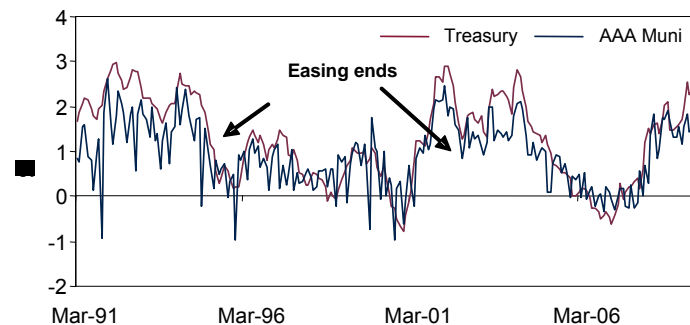
## Cash Finally Being Put to Work



Source: Federal Reserve, Bloomberg L.P., 6/30/09

## Cash Yields Are Historically Low

Five-Year Treasury and Five-Year AAA Muni Bond Spreads vs Cash Equivalents



Source: Bloomberg L.P., 9/30/09

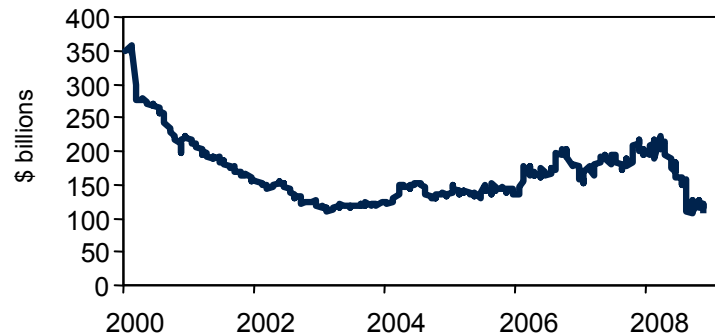
# Economic and Investment Overview

## Bonds: Protecting the Balance Sheet

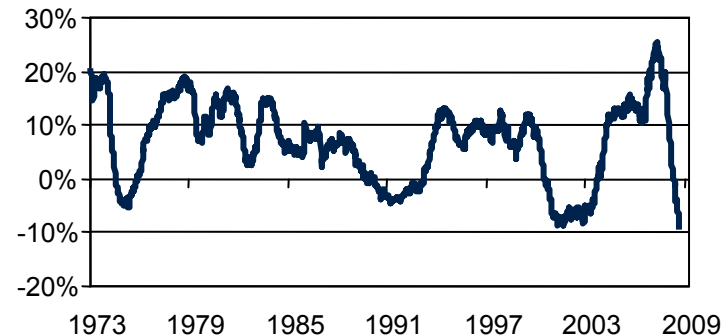
- While adding maturity risk at this point in the interest rate cycle could prove inefficient if the Fed's policies continue to take hold, adding credit risk could be more appropriate.
- One of the reasons for the tension between the supply of and demand for cash emanates from the private sector. Corporations have been active issuers of debt in longer dated maturities, but have been reducing their use of shorter term commercial paper and are trying to reduce their dependence on bank loans. Corporations are extending their debt profile. Wounds from the credit freeze are still fresh, and it appears that most corporate CFOs would rather lock in funding than sink capital into new initiatives. The result is improved credit quality at the expense of capitalizing on potential growth.
- Municipalities are also undergoing similar moves to insulate their liabilities from sharp changes in the short-term funding markets and to reduce their reliance on bank-supplied liquidity.
- "Right-sizing" municipal balance sheets is mandated in most cases, but corporate managers are also adopting this strategy. In both cases, the supply of short-term assets fell away while the demand for safety grew. As balance sheets are bolstered and investor confidence improves, we would expect capital to flow toward credit risk rather than maturity risk.

## Corporate Financing Remains Tight

Non-Financial Commercial Paper Outstanding



Commercial and Industrial Loan Growth (Year/Year)



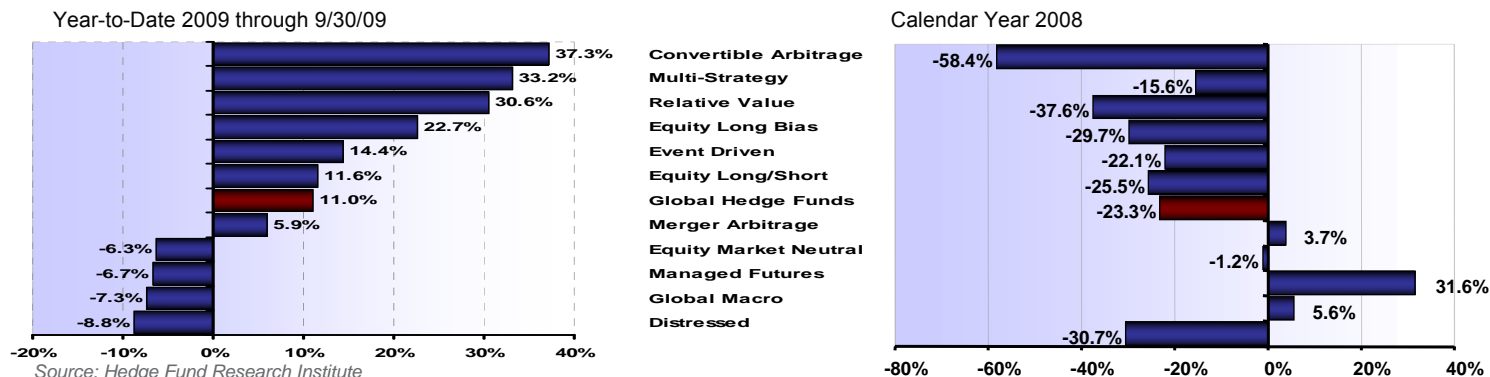
Source (both graphs): Federal Reserve, Bloomberg, data as of 9/30/09

# Economic and Investment Overview

## Hedge Funds: Mean Reversion

- The best performing strategies of 2009 year-to-date were the worst performing strategies of 2008 and vice versa. Most hedge fund strategies have a mean-reverting characteristic, which makes performance chasing a futile endeavor. Hedge fund strategy investments should be judged on a forward-looking basis by assessing the attractiveness of both the alpha-producing opportunity set and the beta of each strategy
- Hedge fund leverage varies widely by strategy. We recommend that investors target strategies with minimal to no leverage for direct allocations, which include fundamental equity long/short, distressed debt, corporate credit and event-driven strategies. Non-correlated levered strategies are accessed through diversified hedge funds of funds.
- If the stock market is bound within a trading range and potential absolute returns are below long-term averages, managers with the flexibility to invest in superior companies and sell short inferior or overvalued stocks are better positioned to generate strong returns without being fully exposed to the overall direction of the stock market.
- Further positive developments for hedge funds include improved fund flows, a slower pace of redemptions and likely legislative change, which will tighten regulation and oversight.

## Last Year's Laggards Are This Year's Winners

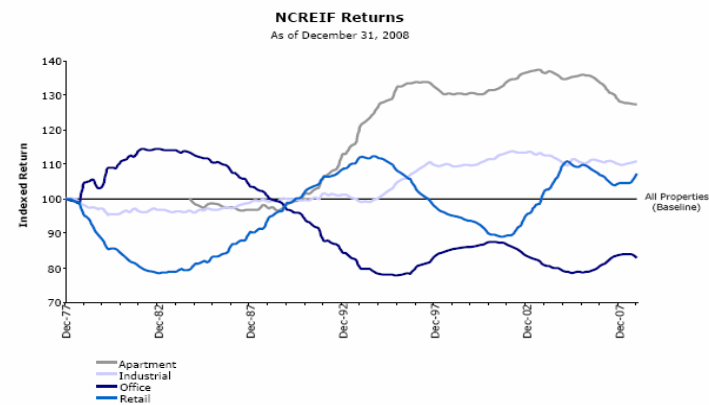


# Economic and Investment Overview

## Real Estate: Weakening Commercial Real Estate Fundamentals

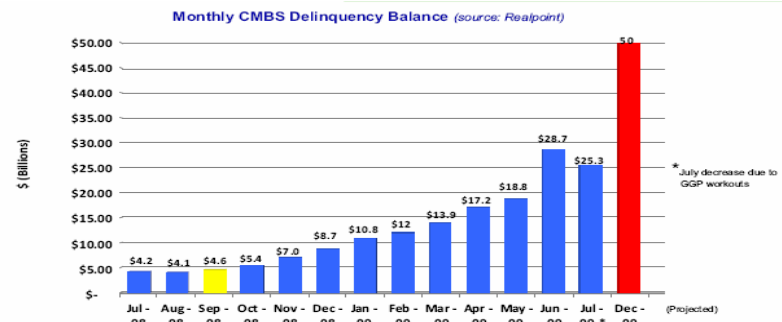
- While the U.S. economy is stabilizing, a number of factors will continue to weigh on commercial real estate fundamentals in 2010. Office property demand will remain anemic because of a lack of job creation. Traditional financing sources have dried up or are impaired, and there will likely be additional regional bank failures ahead. Large bid/ask spreads in real estate valuations will persist given the uncertainty of the market. Cash flows continue to deteriorate as leases roll off, and significant concessions are mandatory to maintain occupancy rates.
- The value of commercial real estate was impacted by the availability of high leverage levels, which led to falling cap rates (net operating income/value). The volume of commercial real estate loans from 2004-2007 amounted to 3x the loan volume from 2000-2003, and the deleveraging process and workout environment will take another two years. CMBS delinquency is nearly 6.5% of the outstanding debt, roughly 6 times what it was 12 months ago.
- The demand for debt is likely to exceed the supply over the next several years as boom-period loans mature and the economy stresses marginal owners. In that case, forced sales by owners and financial institutions of a wide array of debt and equity exposure would be priced at steep discounts. That said, better opportunities to upgrade physical quality and reduce property-level risk are likely to emerge.

## Real Estate Returns Vary by Property Type



Source: NCREIF

## CMBS Delinquency Balances Have Risen 6x



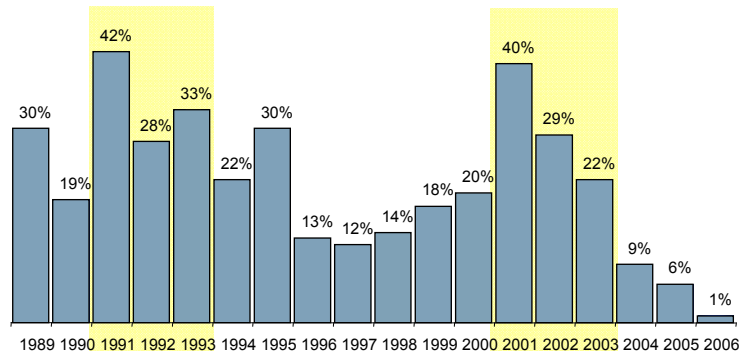
Source: CB Richard Ellis

# Economic and Investment Overview

## Private Equity: The Return of Discipline

- Over the last three years, there has been a breakdown of discipline in private equity investing, with firms paying peak multiples on peak earnings, using excessive leverage.
  - Multiples of EBITDA increased 51% from 2002 to 2007.
  - Earnings crested in the mid \$80's in 2007 and 2008; now estimates for earnings of the S&P in 2009 are \$54, a 39% decrease.
  - Debt/EBITDA multiples increased 51% from 2001 to 2007.
- We believe that a change in private equity investor behavior is taking place, returning to a more disciplined approach. Funds will be smaller with more limited partner-friendly terms, investments will be smaller and will use less leverage. Holding periods will be longer and there will be fewer large public leveraged buyouts, with more carve-outs and private transactions.

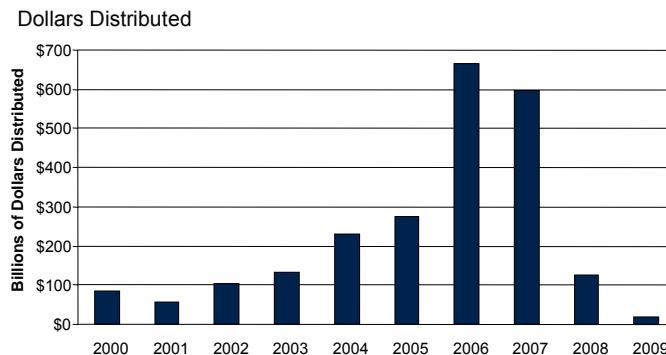
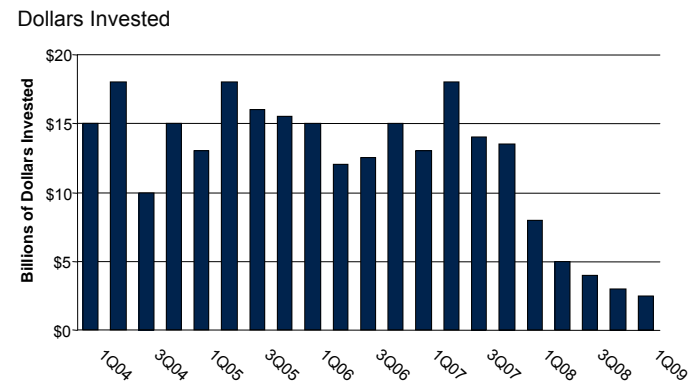
## Past Recessions Have Produced the Best Vintage Years



Source: Cambridge U.S. P/E Benchmarks 2009 Q1

## Investments Down 83% From 2007

## Distributions Down 88% Since 2006



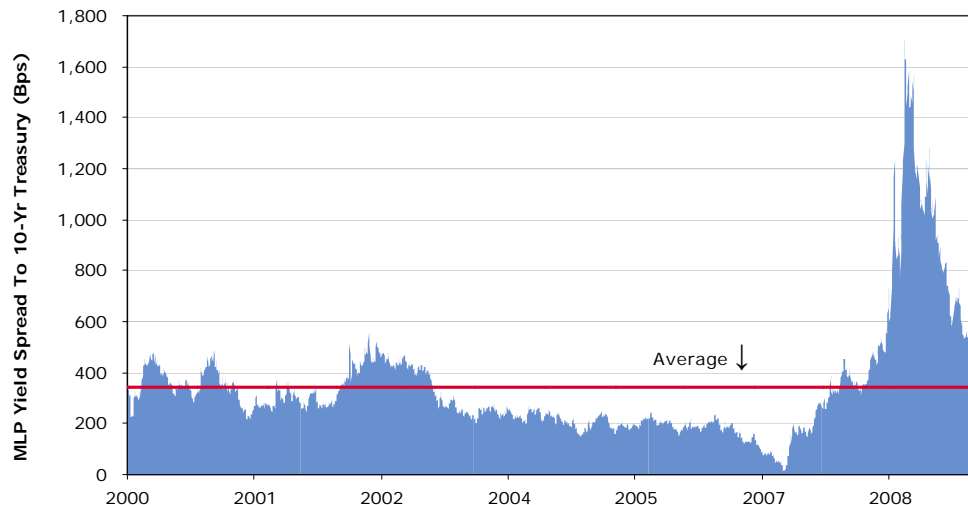
Source: Thomson Venture Economics, 8/27/09

# Economic and Investment Overview

## Energy MLPs: Still Room to Run

- Energy Master Limited Partnerships (MLPs) are still attractive even after their astonishing run in 2009. The Wells Fargo MLP Index was up 14.1% in the 3Q and 50.8% YTD. MLPs are now trading at a median yield of 8.5%, which represents a 520-basis point spread over the 10-year Treasury yield. Since 2000, the average spread has been approximately 350 basis points, so MLPs still have room for improvement relative to historical norms.
- Even without yield contraction, we still expect MLPs to achieve attractive total returns given our longer term outlook for moderate growth in distributions of 3-5% and current yield levels.

## MLPs Offer Attractive Yield Advantage Over Treasuries



Source: FactSet, data as of 9/30/09