

The Atlantic Trust Advisor

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Can volatility really be an investor's friend?

Since the first of the year, the drumbeat of unsettling economic and market news has been steady—large financial asset write-downs, a weak dollar, oil at record highs, a slowdown in consumer spending. Together, these factors have kept persistent downward pressure on stock prices. When all the signs seem to be saying “caution,” it’s difficult to think of volatility as anything other than disconcerting and damaging, especially when combined with talk of recession. But for well-diversified and long-term investors, a volatile downward market presents plenty of opportunity.

There’s no sense pretending there aren’t “issues” out there, says Jeff Thomas, chief investment officer at Atlantic Trust. Equity markets closed out 2007 and entered 2008 on a negative note, with many of last year’s strong performers giving back much of their 2007 gains in early 2008. Headlines about the housing and credit problems persist. Notes Thomas,

“The severity of the market reaction to credit issues reminds us again that U.S. capital markets continue to thrive on ‘creative destruction.’ While global liquidity remains ample, any recovery in stock prices must be preceded by more stable credit markets. But that’s just one part of what’s unfolded. What we’re focusing on is that it’s a *good* time to deploy capital. The underlying dynamics around the world are still intact—in fact, quite robust. Stability may make you feel good, but volatile times are what creates opportunity. And the biggest opportunity for building wealth long-term is to take advantage of those who are thinking short-term.”

In uncertain market and economic periods—not to mention an uncertain political climate—it’s all about asset classes, says Michael Battey, managing director at Atlantic Trust-San Francisco. “It’s certainly appropriate to say ‘buy an investment when it’s less expensive,’ but there’s a big difference in an investment being *cheap* and just being *less expensive* than a year ago,”

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ATLANTIC TRUST

PRIVATE WEALTH MANAGEMENT

Opportunity in the Midst of Volatility

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says Battey. “When volatility is stronger, investors should focus on asset allocation and managers who have a sound process that stays consistent.”

Put simply, according to Battey, when the market is giving a significant discount from its peak, investors should be buying across all asset classes that look reasonably priced for the five-year cycle to come. “If you’re uncomfortable doing that all at once, you should certainly be thinking about doing it incrementally,” he says.

Taking advantage of the opportunity inherent in volatility, our Asset Allocation Committee (AAC), led by Thomas, made adjustments to recommended portfolios in January, taking 5 percent from *equities* and re-allocating that amount to *hedge funds*. The shift recognizes equities’ five years of good returns and a possible 12-month period of uncertainty ahead. “We’d rather see a slightly bigger allocation to an asset class that has less exposure to market risk,” says Thomas. (See *Hedge Article*, page 6)

This increased slice of diversification is in keeping with Atlantic Trust’s primary mantra, notes Langston Turner, managing director in the Houston office. “Call it a broken record, but we constantly preach the value of diversification. It certainly helps weather storms. If you look at those on the leading edge of investment management, such as endowments and foundations, they certainly are allocating heavily to hedge funds because of their nimbleness and ability to take advantage of dislocations in both directions. Volatility can be softened by giving up something on the upside in order to have better protection on the downside.”

Municipal bonds are another investment that deserves a close look during uncertain times. Many different types of fixed income securities have come under pressure in recent months due to the rising risk of default typically seen in the late stages of a business cycle. Investors have flocked to the relative safety of Treasury securities and created significant relative value in municipal debt. Yields for the highest quality muni bonds are now above those of similar maturity Treasury bonds, despite the tax advantage found in municipal bonds. (See *Municipal Article*, page 8)

In some sense, the market’s recent volatility is entirely predictable—it’s simply part of the historical nature of markets. But not knowing when a downturn will begin—or end—is part of what can be unnerving. The year 2007

may be more “normal” because investors experienced both good months and bad months in one year, unlike recent periods of mostly one or the other. But along with fresh memories of 2000-2002, it’s the “not knowing” that has clients turning to Atlantic Trust for reassurance, affirmation and perspective. “It’s always important to give a refresher on the positive news,” says Thomas. “Fourth quarter earnings from non-financial and non-homebuilder companies were generally quite positive. A company’s rate of growth may be slowing, but if growth slows from say 10 percent to ‘only’ 8 percent, well, that’s certainly still significant growth. What’s most important right now is that our clients know that we have our eye on the ball.”

“Call it a broken record, but we constantly preach the value of diversification. It certainly helps weather storms.”

The multiple balls that Atlantic Trust is eyeing are the actions of both the Federal Reserve and the administration to stimulate the economy, the rate of inflation (which is above the Fed’s “comfort zone” right now, says Turner) and uncertainty about both the presidential election and the Summer Olympics. As Turner puts it, “When the torch gets passed in China, is the pace of growth in China sustainable or was much of it due to building out and preparing for the Olympic Games?”

Atlantic Trust predicates its wealth management philosophy on capital preservation, says Turner. “Everything we do supports positioning our clients to have good capture on the upside and significant outperformance on the downside. I’ll make the argument all day that while we add value *all* the time, I believe Atlantic Trust adds the *most* value during times of market dislocation.”

It may sound trite to say that we can always learn lessons from unsettling periods, but it’s true. “This is not only a great time to exploit certain opportunities, but to practice self-awareness about staying focused on the long-term goal, even though conditions may not feel good right now,” says Thomas. “I like this quote from the British mathematician Jacob Bronowski: ‘*Knowledge is an unending adventure at the edge of uncertainty.*’ If knowledge is a goal for investors, and it certainly should be, then this is a time to become familiar with the ways that volatility can actually be your friend.” ■

Wealth Transfer Strategies for Tough Economic Times

Wealth Strategies Group

The Wealth Strategies Group at Atlantic Trust integrates tax, estate, financial and investment planning through sophisticated assessment of goals to achieve multi-generational capital preservation, family business continuity and strategic philanthropic objectives.

Savvy investors have always known that an economic downturn presents opportunities for anyone willing to bet on recovery. Similarly, with estate planning, there are distinct advantages in taking action while market values and interest rates are low. Transfer property now, and you can reduce the size of your taxable estate while giving beneficiaries substantial upside potential.

“Difficult economic conditions present an opportunity to benefit those who are less advantaged—whether they are family members or charities—and who can use the money sooner, rather than later,” says Linda Beerman, managing director at Atlantic Trust-Atlanta. Depending upon your circumstances, here are some strategies to consider.

Scenario 1: You have plenty of cash and would like to help family members who have less.

You can give \$12,000 per year to as many recipients as you like without paying gift tax. Spouses can combine this annual exclusion to give jointly \$24,000 to any person tax-free. If you want to give away more than that, you can either count your gift against the \$1 million lifetime exemption—the total of taxable gifts each person can make without incurring gift tax—or, if you have used up the exemption, pay gift tax of 45 percent.

Another option, which will not require you to pay gift tax, is to lend family members the money—for example, to help them buy a house or start a business at a time when credit is tight. These intrafamily loans require the formalities of a bank loan, including a note and security, but the interest rate can be more favorable than it would be at a financial institution—you are required to charge the applicable federal rate (AFR). In April, the AFR for long-term loans—those lasting more than nine years—is 4.4 percent.

Scenario 2: You want to transfer non-cash assets in excess of the annual exclusion.

You can leverage your lifetime exemption by seed funding a trust with all or part of your exemption and selling significantly more assets to the trust in return for a promissory note with

interest. (Again, the AFR applies.) This strategy is typically referred to as an installment sale to a defective grantor trust (IDGT). “Since you will need to set a fair sale price, it is preferable to use assets that are not difficult to value,” says Judith Saxe, managing director at Atlantic Trust-Boston. When asset values are down, the asset price will be lower

“Current low interest rates and depressed asset values make charitable lead trusts especially appealing.”

than it would otherwise be, making it an advantageous time for such an arrangement. The use of a trust protects the assets from creditors and affords the opportunity for income tax planning.

For trusts that will benefit grandchildren, you can apply your generation-skipping transfer tax (GST) exemption when you enter into the transaction. This exemption permits you to give up to \$2 million to grandchildren during life or at death without incurring a 45 percent generation-skipping tax on top of any gift or estate tax. If you allocate your GST exemption to the initial seed gift to the trust, you will be able to shelter all of the assets in the trust from the GST tax.

Scenario 3: A liquidity event, such as a sale, is on the horizon, or you expect depreciated assets to recover.

You can transfer the appreciation at little or no gift-tax cost with a grantor retained annuity trust (GRAT). The idea is to put the asset into a short-term irrevocable trust and retain

Managing Future Risks

The latest market turbulence underscores the need to provide for maximum flexibility when structuring estate planning vehicles. The following are some ways to do that, especially when creating new trusts:

- Locate your trust in a trust-friendly state, and give the trustee the authority to move the trust if changes in the law make it advantageous.
- Permit the trustee to substitute high performing assets for underperforming ones.
- Choose a trustee who can actively manage the trust investments with an eye towards market fluctuations.
- Give the trustee broad power to adapt the trust to changing circumstances, including the ability to decant the trust—to pay out funds from one trust to another. ■

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Wealth Transfer Strategies for Tough Economic Times

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the right to receive an annual annuity stream equal to the value of what you contribute plus interest at a rate set each month by the Internal Revenue Service (the Section 7520 rate). In April, this rate is 3.4 percent. If you survive the trust term—a condition for the GRAT to work—any appreciation in the trust when the annual payments end passes to family members. “On the other hand, if the appreciation never occurs, you are no worse off. In this case, the trust would satisfy its payout obligations by returning some or all of the assets to you,” says Daryl Allen, senior vice president at Atlantic Trust-Houston. If the first GRAT was unsuccessful as a result of lack of performance of the underlying assets, you may want to contribute the assets into a new GRAT, which has a better chance of succeeding because it is starting from a lower valuation.

This technique is not efficient for multigenerational planning, since you cannot allocate the GST exemption until the trust ends and the appreciation in the asset has already occurred.

Scenario 4: You want to transfer assets that are difficult to value.

“With these assets, such as closely held stock or real estate, a GRAT offers an additional benefit,” says Saxe. By expressing the annuity as a percent of the initial value of the GRAT, you permit the trust to simply pay a larger annuity (at no gift-tax cost) if the IRS determines the property is worth more than you initially figured.

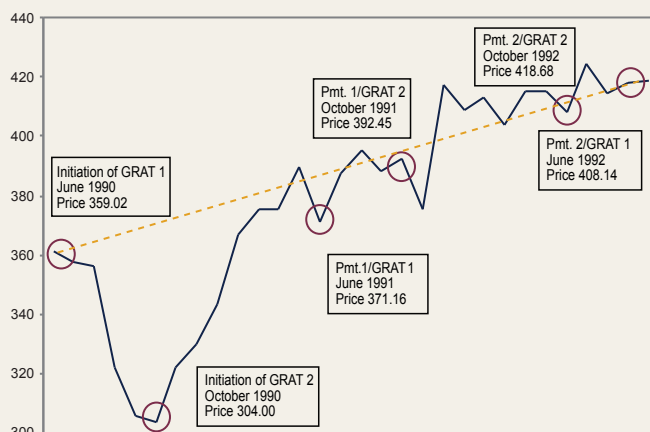
Scenario 5: You want to benefit charity and, ultimately, family.

“Current low interest rates and depressed asset values make the charitable lead trust especially appealing,” says Allen. This device resembles a GRAT except that the initial payout goes to one or more charities rather than to you. After that, the remainder goes to your family. Most donors use the lead annuity trust with the hope that the trust investments will yield more than the trust must distribute. If that doesn’t happen, the trust might be depleted by the end of the term, leaving nothing for family.

“The basic estate planning techniques work extremely well in down markets, assuming the markets eventually come up,” Allen says. By taking these steps now, you have a chance to turn setbacks into advantage. ■

Wealth Transfer Opportunity

The current market conditions may create a great opportunity for Wealth Transfer planning. Reflecting on prior markets provides insight into the opportunity. Let’s take a look at the recessionary time period of late 1990 and early 1991 followed by the market’s recovery through 1992 as a test ground.



Source: Bloomberg L.P.

To test the Wealth Transfer opportunity, let’s compare a GRAT created with \$5 million of cash before the dislocation of the market (June of 1990) to one created at the bottom of the trough by the dislocation (October of 1990) and use the S&P 500 as our measurement of performance during the two GRATs terms (both being 2-year terms).⁽¹⁾ The performance would have been as follows:

Table 1

Date	S&P 500	Percent Return
June 1990 ⁽²⁾	359.02	N/A
Year 1	371.16	3.38%
Year 2	408.14	9.96%
October 1990 ⁽³⁾	304.00	N/A
Year 1	392.45	29.10%
Year 2	418.68	6.68%

Such performance in the underlying asset of the GRAT would result in the following transfer of value:

Table 2

Date	Amount Transferred
June 1990	\$0 ⁽⁴⁾
October 1990	\$883,871

It remains to be seen if this current market will operate as the market in 1990–1992. However, if it does, there is a greater opportunity for Wealth Transfer now, considering the current interest rate environment. In 1990, the Section 7520 rate was 10.6 percent while the current Section 7520 rate is 3.4 percent. With the same performance and the preferential current 7520 rate the results would be as follows:

Table 3

AFR	Amount Transferred
10.60%	\$883,871
3.40%	\$1,454,002

Additional Notes

¹ These GRATs have two-year terms and the annuity amount paid at the end of each year is the same. Further, based on the annuity amounts the value of the grantor’s retained interest is equal to the value of the property transferred to the trust, resulting in a remainder (and a gift-tax value) of zero.

² GRAT was created on 6/30/1990 and the annuity paid on 6/30/1991 and 6/30/1992.

³ GRAT was created on 10/31/1990 and annuity was paid on 10/31/1991 and 10/31/1992.

⁴ Based on the performance of the underlying assets of the GRAT created June of 1990 no wealth was transferred. In satisfaction of the second annuity payment all the remaining asset of the GRAT were returned to the grantor and the value of those assets transferred to the grantor was less than the annuity amount due the grantor.

Investment Review and Outlook

By Alfred F. Kugel, CFA®, CIC
Chief Investment Strategist

Spring Is Here!

Although you can't tell it from the economic news or the stock market, spring has arrived on the calendar. Certainly, the hours of daylight are clearly longer than they were not long ago, and we have flirted with getting the temperatures up into the 60's during the daytime. Of course, while the calendar is inexorable, it is not so assured that spring will come to investors all that soon. The bad news is that the economic data reported during March have been fairly consistently weak, in many cases worse than expected. As a result, there has been a lot of talk about recession; although we do not believe that the evidence to date shows that a recession is assured, the risks have certainly risen.

The good news is that the risks have been clearly noted by the authorities, and actions have been taken on a variety of fronts to head off or mitigate a possible downturn in the economy. For example, the Federal Open Market Committee has now reduced the Federal Funds rate quite sharply from 5¼ percent last September to just 2¼ percent currently, and a further reduction of 25 or 50 basis points seems probable at the next scheduled meeting on April 30. On the fiscal side, Congress has enacted and President Bush has signed a fiscal stimulus package estimated at \$168 billion.

As to the stock market, prices fell sharply early in the year as investors faced the fact that financial institutions had to write-down the value of certain assets on their balance sheets—mostly related to sub-prime mortgages—by a huge \$150 billion, which meant that fourth quarter profits for the S&P's 500 Stock Index fell by more than 20 percent from their level a year ago, with additional write-downs necessary in the first quarter.

As a result, the market return for the first three months of 2008 was a negative 9½ percent. Although we still have to work our way through the fallout from the mortgage problems and credit crunch, we believe that the market will begin to perform better as the year progresses and that it is a reasonable expectation that equities will make it back into the plus column for this year as a whole.

Monetary Stimulation

The most significant response to the problems in the housing and credit markets has been a sharp shifting of monetary policy since mid-year. Following up from an initial 50 basis points or one-half of a percent cut in the Federal Funds rate last September, there has now been a cumulative reduction of 300 basis points. Moreover, we believe it is likely that an

additional cut in the rates will be forthcoming at the April 30 FOMC. Normally, this would be strong medicine for a weakening economy. However, the drag from the credit crunch has offset some of the effects of the stimulative monetary policy.

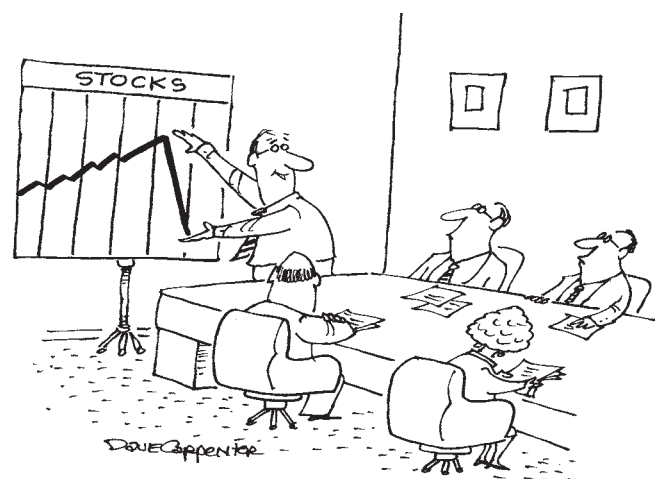
In addition to the rate cuts, the Federal Reserve has provided large amounts of credit to commercial banks and, most recently, to investment banks, by taking securities of the agencies and other issuers as collateral. Moreover, the regulatory authorities have raised the ceilings on conforming mortgages and moved to ease capital requirements on Freddie Mac and Fannie Mae, so that these institutions can increase their mortgage financing activity.

Of course, monetary stimulation doesn't produce instant economic effects but acts with a lag, generally of at least 6 to 9 months. As a result, we do not look for any immediate positive impact on economic growth, which will probably remain relatively sluggish until late spring before accelerating in the second half of the year.

Fiscal Stimulation

In mid-January, President Bush proposed a fiscal stimulus package that he urged be timely, targeted and temporary, with a total tax cut on the order of 1 percent of GDP (around \$150 billion), and this has now been enacted. About two-thirds of the stimulus would take the form of tax rebates of \$600 to individuals earning between \$3,000 and \$75,000 annually (with the numbers being doubled for couples filing joint returns). In addition, there would be a credit of \$300 per child. Businesses would receive the other third of the stimulus, being allowed to deduct 50 percent of the cost of new capital equipment immediately.

Although it will take time for the Treasury Department to gear up for the massive distribution of some 130 million rebate checks, it is anticipated that payments will start in



"A TEMPORARY SOLUTION WOULD BE TO WHITE OUT THIS PART OF THE CHART."

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Investment Review and Outlook

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early May and be completed by mid-July. Of course, no one knows just how much of this money will actually be spent, as opposed to saved or used to pay off debt, but the stimulative impact should be substantial.

The Economic Fallout

The key question for investors is how much of an impact will the credit squeeze have on economic activity and how much relief can be expected from the monetary and fiscal stimulus now on its way. Certainly, it seems likely that there will be additional negative effects in the short run, and the latest government data show that the economy was very sluggish in the first quarter of 2008, and this pattern will likely continue in the early part of the current quarter.

The latest quarterly data cover the fourth period of 2007 which showed the economy growing weakly at a rate of 0.6 percent annually. However, the actual situation was somewhat better than that suggests since real final sales, excluding substantial inventory liquidation, actually increased at a 2.4 percent rate. For 2007 as a whole, real GDP increased by 2.2 percent after allowing for a drag of a full percentage point as a result of the sharp decline in residential construction. (This means that the rest of the economy continued to chug along at a very respectable 3.2 percent, which explains why earnings other than in the housing and financial sectors have continued to be relatively strong.)

At this point, our expectation is that housing activity will remain weak and that the credit “crunch” will cause some additional softness, so that the current slowdown will likely continue well into the spring. However, it should be noted that our forecast envisages a “back-end loaded” year in 2008, with the weakest period being the first quarter, followed by a gradual acceleration allowing improvement to a significant rate of activity by the fourth quarter. ■

S&P 500 Index (Weekly Close)

December 29, 1995–March 27, 2008



Source: Federal Reserve Board

Hedge Funds: Preserving the Upside While Protecting the Downside

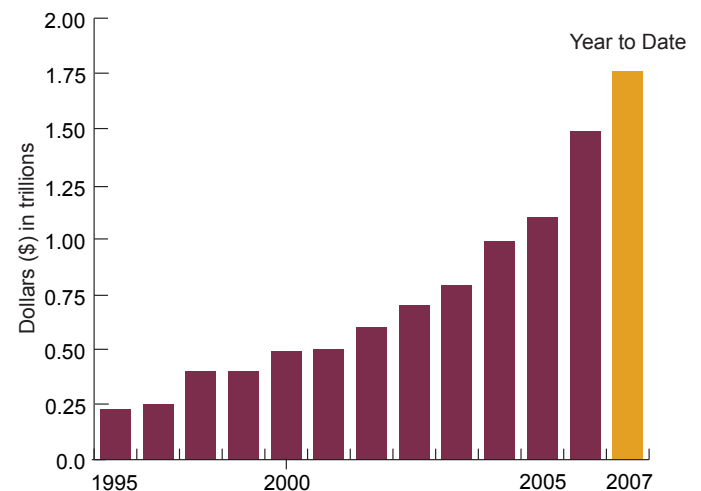
Multi-Manager Investment Team

The name George Soros may come to mind when thinking about hedge funds, but the “founding father” of hedge funds was actually a financial journalist for Fortune magazine. In 1949, Alfred Winslow Jones decided to try his own hand at investing, establishing an investment partnership to capitalize on two investment tools—using leverage to buy shares and using short selling to avoid market risk. A fellow Fortune journalist published an article in 1966 about Jones’ work—coining the term hedge fund. George Soros and his Quantum Funds weren’t far behind.

As of last quarter 2007, there are approximately 10,000 global hedge funds with an estimated \$2 trillion in assets under management and growing at 30 percent per annum. Institutional investors have been leading the investment inflow with new money flow, with \$80 billion anticipated to be invested by institutions in the fund of hedge fund sector.* (See graph below)

Booming Business

Hedge funds have been one of the hot investments in recent years. As of December 2007



Source: Hedge Fund Research

Because of their often high returns to investors and their high profile, hedge funds are also attractive to accredited, high net worth investors and not just because of their cachet—many

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Hedge Funds: Preserving the Upside While Protecting the Downside

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hedge funds offer strong “all weather” returns, additional portfolio diversification and risk reduction. A hedge fund’s function is to pool investors’ assets within a fund and invest in varying market sectors through leveraging practices, which may increase the risk of investment loss. As their name implies, hedge funds can offer a “hedge” against losses in a portfolio from other assets.

Strategic asset allocation is the foundation of wealth preservation for Atlantic Trust’s clients. Through the Multi-Manager Investment Program (MMIP), clients can strengthen their investment diversification by investing with top institutional managers in hedge funds and other alternative investments. It’s a basic tenet of modern portfolio theory that adding uncorrelated assets—those that don’t move in tandem with others—to a portfolio helps drive down overall portfolio volatility. A long/short equity fund, the original hedge fund style, aims to profit from both rising and declining stocks. Shorting stocks allows the manager to make money from the decline of a stock’s price; at the same time, going long on stocks in the portfolio means investors can make money the old-fashioned way—by participating in a rising market. The combination of strategies tends to stabilize returns and reduce volatility. While gains can be significant in up markets, many long/short equity funds prove their mettle when markets drop significantly.

“...the most important criteria for our selection of hedge funds are manager selection and understanding their specific risk factors...”

“Unlike traditional investments, which expose investors to market risks, some types of hedge funds can help minimize those, but they do expose investors to the risks of the particular hedge fund or hedge fund style” says Paul Lisanke, vice president at Atlantic Trust-Boston. “That’s why the most important criteria for our choice of hedge funds are manager selection and understanding their specific risk factors and investment skills.” Selecting a new manager requires a vote of the Multi-Manager Investment Committee, which takes full responsibility

in the search, screening, selection, and monitoring of an investment manager. The search involves a formalized due diligence and research process in which an in-depth fundamental and qualitative analysis is conducted in order to select a manager most likely to sustain strong long-term investment performance.

“Volatility certainly has been on investors’ minds since the beginning of 2008.”

Another type of investment instrument on the MMIP platform is a “fund of hedge funds,” which invests in other hedge funds, and for many clients is the most appropriate way to take advantage of hedge funds’ features. A fund of hedge funds may hold 20-40 managers with different styles and strategies, which offers an important additional layer of diversification. The most recent addition to the MMIP platform to which our clients have unique access is a global long/short fund of hedge funds.

“Volatility certainly has been on investors’ minds since the beginning of 2008,” says Lisanke. Our Asset Allocation Committee (ACC) has reduced the long-only equity exposure to the all-equity, growth and balanced model portfolios by five percent, as mentioned in our cover story. Market volatility has increased due to housing, credit and now employment concerns. The AAC advises that large-cap value and non-U.S. equities be trimmed in clients’ long-only equity portfolios. They also recommend that the five percent reduction in long-only portfolios be re-allocated to hedge funds. A global long/short fund, such as the one most recently added to the approved MMIP manager selection list, may be a smart way to still be in equities, but with less volatility. Lisanke notes, “This is a prudent move for many investors right now.”

The Multi-Manager Investment Team would like to provide some guidance to our clients on how proceeds of the re-allocation of the five percent is invested. “We feel that this period of increased uncertainty will actually be a benefit to hedge fund managers on our MMIP platform, who will be opportunistic in sizing up various asset prices on a relative basis. In addition, hedge funds with significant short positions can provide protection for clients’ portfolios and generate alpha on the short side,” states Lisanke. ■

*Source: *Absolute Return*, Hedge Fund Intelligence, 2007.

Municipal Bond Appeal

Asset Allocation Committee

Since preservation of capital is a universal investment objective for our clients, bonds are typically well-represented in our clients' investment portfolios. Of course, each client's bond allocation is determined individually, yet virtually every client has a healthy "core" allocation to bonds. Over time, as our outlook on interest rates changes, we may move bond allocations near the upper or lower end of the targeted ranges established for each client.

"We believe that recent events have created a significant opportunity in municipal bonds."

For the past several months, our Asset Allocation Committee (AAC) viewed bonds and Treasury securities, in particular, as "overvalued." We believe the value of Treasuries remained inflated due to the amount of Fed easing already factored into the yield curve—the relation between the interest rate and the time to maturity—and the effect of negative real interest rates—the nominal interest rate minus the inflation rate—on the broad economy. During that period, the AAC had recommended that client allocations to bonds generally should be at the lower end of targeted ranges.

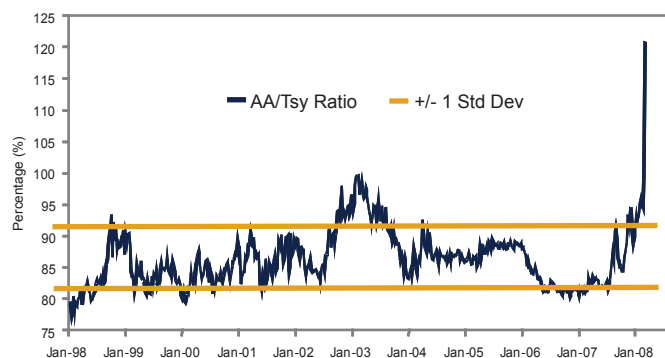
However, more recently, municipal (muni) bonds have become increasingly attractive as yields on high grade municipals have reached historically elevated levels relative to other fixed income alternatives. "We believe that recent events have created a significant opportunity in muni bonds, enough so that the AAC has recommended raising bond allocations (and/or extending duration) and taking advantage of the potential for attractive risk-adjusted returns in the months ahead. While this is a rare 'tactical'

(vs. 'strategic') recommendation from the AAC, it is one that we believe can significantly benefit our clients," said Gary Pzegeo, managing director and head of Fixed Income and a member of the AAC.

Atlantic Trust investment management teams are constantly looking for unique market conditions that create investment opportunity, especially when such opportunities involve increasing positions in asset classes "well known" to Atlantic Trust. The current situation in the municipal market appears to qualify as such an opportunity. As of March 2008, the yield on AA-rated 10-year municipal bonds is about 15 percent above that of similar maturity Treasury notes.

AA General Obligation As Percentage of 10-Year Treasury

January 1998–January 2008



Source: Atlantic Trust, Bloomberg L.P. and Municipal Market Advisors.

This unusual yield differential is due primarily to uncertainty surrounding several municipal bond insurers. In addition, the failure of a majority of Auction Rate Securities (ARS) and the collapse of leveraged municipal strategies utilized by certain hedge funds is adding heavy supply to the municipal market and creating an anomaly in yields. While this anomaly could persist for several months, when it does eventually correct (i.e., municipal yields return to a more normal relationship with Treasury yields), municipal bonds should materially outperform Treasuries. ■

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