

The Atlantic Trust Advisor

Technology Stocks: New Cycles, New Opportunities

By Chuck Jones
Senior VP, Technology Analyst

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You may remember it well: In 1999, the technology-heavy Nasdaq rose 86%, Amazon.com's CEO, Jeff Bezos, was *Time Magazine's* Man of the Year, and we were introduced to such "new economy" companies as Webvan and Pets.com. It all came to a screeching halt starting in March 2000, when the Nasdaq peaked at 5133 only to close a month later at 3321. Seven years later, the Nasdaq is still almost 50% below its euphoric high, yet today's headlines tell us that "Tech is back."

Chuck Jones, senior vice president and technology analyst, agrees that many areas of the technology sector are very attractive—but this time for different reasons.

"Technology has settled into mature industry status," says Jones. "Revenue growth rates are about two times GDP growth, whereas they used to be three, four, or even ten times faster. While certain companies are growing much faster, the technology industry as a whole has

become a much larger component of the U.S. economy and therefore its growth rate is hindered. We've also seen valuation compression during the past five years, especially for large-cap stocks. Intel, for example, has doubled its earnings since 2002, but the stock has been essentially flat. The technology sector will never go back to what many remember as 'the glory years,' but it is certainly out of the 2000–2002 doldrums." With technology earnings growth faster than the overall economy, but P/E multiples about in line with the market, many tech companies look to be compellingly valued.

Jones, who spent 16 years with IBM before becoming a technology analyst, monitors, analyzes and recommends technology stocks for Atlantic Trust's Core Growth Equity and Equity Income offerings. Technology stocks are important to core portfolio holdings because of their alignment with wealth preservation goals.

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ATLANTIC TRUST

PRIVATE WEALTH MANAGEMENT

Summer is the Ideal Time to Take Stock of Old Trusts

Wealth Strategies Group

Often clients come to us with an assortment of trusts in place, created during different stages of their lives and designed to serve various purposes. Typically they haven't looked at those trusts in a while. Meanwhile, children have grown up, senior family members have matured and, if all went well, investments have prospered. But unexpected problems may also have arisen. Perhaps assets appreciated so rapidly that beneficiaries are in danger of becoming financially dependent on income from the trust. Or maybe there is a danger that individuals with no financial acumen will dissipate age-based payouts they are about to receive.

As families get together for summer vacations and to mark milestones passed during the winter months, it is a good idea to take stock of your estate plan and estate planning goals. This is the time to ask, "Do the trusts still fulfill your objectives and what, if anything, can you do if they do not?" says Daryl M. Allen, senior vice president at Atlantic Trust.

Many trusts are irrevocable, meaning that the grantor—the person who created them—cannot change their terms. "However, depending on the provisions of the trust, the trustee's powers and state law, there may be strategies to administer them more flexibly," Allen says.

"When people do extensive planning over many years and use different lawyers, they can end up with a patchwork quilt of trusts," adds Linda S. Beerman, managing director at Atlantic Trust. Ideally old trusts, put in place incrementally, should be coordinated to complement each other. An inventory of old trusts should also be a prelude to drafting new ones. The following are some trouble spots that commonly arise:

Distribution ages are earlier than you would prefer.

A couple who consulted us recently had set up trusts for each of their three children a dozen years ago and specified that the principal should be paid out half at age 21 and the rest at 35. Since then they have discovered the asset protection and other benefits of lifetime trusts. They would prefer that their children not receive large sums of money that might be squandered at a young age or fall into creditor's hands.

"We proposed two strategies for these clients," says Judith A. Saxe, managing director at Atlantic Trust. "One was not to put any additional money into the trusts. Another was to transfer some of the assets—low-basis stock in a start-up company that was expected to go public—out of the trust before it exploded in value. Those shares, exchanged for cash, could go into new, longer-term trusts to benefit the same individuals, but with a different payout schedule."

Trust assets have grown too large.

Sometimes, especially when trusts are funded with shares in a start-up company, the property appreciates more dramatically than anyone expected. When that happens and the trust requires distributions at specific ages, there is a risk of substantial wealth going to beneficiaries before they are sophisticated enough to manage it.

A popular solution that works in some cases is to create a limited liability company or a limited partnership, funded with other family assets, and have the trust invest in that entity. The trust would then own a percentage of the partnership. "Instead of receiving property outright at the designated age—assume it is 21—the beneficiary would receive an interest in the partnership," Beerman explains. That partnership interest, in turn, would entitle him or her to an income stream, though not nearly as much as the beneficiary would have received otherwise.

"Whether or not a trustee can create this structure will depend on the trust terms and state law," says Allen. Sometimes it may be necessary for the trustee to present the plan to the court and get permission to reform or revise the trust to better meet the grantor's wishes.

Individual trustees are not the people you would have chosen today.

"Often the trust document offers a solution to this problem if the current trustees will cooperate," says Saxe. For example, assume the trust provides that John and Mary are co-trustees, and that if neither of them can play that role, a corporate trustee will step in. By asking John and Mary to both resign as trustees, it would be possible to appoint the corporate fiduciary.

In another case, the client had appointed an individual as co-trustee with a corporate fiduciary without specifying that the financial institution should have sole discretion over investing trust assets. As it happened, the individual didn't feel qualified to participate in investment decisions.

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Protection: Exiting an Investment Strategy

By Faith Tsao, CFA
Sr. Vice President, Director of Traditional External Investments

Underpinning our investment offering is our clients' universal preference for capital preservation, growth and liquidity. Our Multi-Manager Investment Committee (MMIC) helps our relationship managers deliver solutions that address these goals by practicing a disciplined process of selecting, monitoring, and terminating external managers.

The senior investment professionals who are members of the MMIC understand that the preservation, or protection, of wealth requires them not only to know when to enter an investment strategy, but also to know when to exit. The specific criteria we follow in the manager termination process are well defined, yet complex and critically important to making wise investment decisions.

Manager Selection: Characteristics

Through informed analysis and due diligence, we look for the following:

- *Knowledge and experience of a manager who has been through more than one market cycle*
- *Consistent implementation of a disciplined investment process*
- *Proprietary research that provides insight ahead of consensus*
- *Stable and ethical organization*
- *Proven track record through up and down markets*

Manager Dismissed: Criteria

The dismissal criteria followed by Atlantic Trust for releasing a manager is written into our investment process and has been approved by the Investment Policy Committee.

When an investment manager is removed, other investment options are made available. Red flag termination criteria include:

- A. *Head manager turnover and the entering manager is inexperienced, has not managed a similar style portfolio, or has demonstrated a poor prior performance track record*
- B. *Departure of key investment professionals or senior management*
- C. *Continuous under-performance versus peers and benchmarks due to poor stock selection*

- D. *Permanent style or investment process change/deviation*
- E. *Significant change in asset base that could impair the investment process*
- F. *Fees or other significant operational changes*
- G. *Atlantic Trust clients own more than 10% of strategy assets*

The Complexities

While all criteria are straight-forward, not all can lead straight to a clear-cut determination for dismissal. Criteria B and C require much more research and analysis.

For criteria B, the impact on performance is often not immediate, especially if the remaining Team practices the same investment disciplines. There are examples of both continued success as well as eventual failure following a key investment professionals' departure and many variables are considered before releasing a manager.

For criteria C, often a period of out-performance is followed by under-performance. The length of the performance cycle can vary depending on market conditions. We typically look at the factors behind the under-performance when there are no changes to other criteria. For example, is there a lack of exposure to a hot sector and/or a market cap range they normally avoid, but there is decent stock selection in other areas? Have they made persistent bad bets on stocks that would have appeared to meet their investment criteria? Could the mistakes have been avoided?

Since most of our outside managers have investment horizons of three to five years, it is not unusual for the newer investment opportunities to take some time to be recognized by other investors. Regression to the mean is a powerful reality within manager universes, and frictional costs inherent in changing managers can be high. For the most part we have found that patience is oftentimes rewarded during shorter term periods of manager under-performance.

On average outside manager turnover is about 10% per year for termination. There is no secret formula in manager selection or dismissal. It truly is more art than science. We believe that our experience and judgment have led us to the right decisions for the protection of our clients more often than not. ■

An Interview with Alexander J. Roepers

Manager, Rodinia Fund and
Quest Capital Partners



Alexander Roepers is a visionary and the President of Atlantic Investment Management, Inc., founded in 1988. Prior to founding Atlantic Investment, Alexander directed corporate development with Thyssen-Bornemisza Group in New York, where he bought and sold businesses. His notable Dutch family heritage stems from a century in the print business in the Netherlands, giving him the depth and respect for businesses which offer tangibles, the focus of his universe. Being a linguist allows Alexander the opportunity to communicate directly with companies, not having to rely on analysts. Alexander received his Master of Business Administration from Harvard Business School and Bachelor in Business Administration degree from Nijenrode University, the Netherlands School of Business.

Q What style of investment do you practice?

A There is a lot to be said and respected of global 'old economy' companies that generate value and deliver a finished product to the marketplace. The methodology that we practice comes from this respect. From a carefully selected, well-defined universe, with a private equity approach to due diligence, we invest globally in select mid-cap publicly traded companies. Our objective for investment is a concentration from the highest conviction, combined with a unique style of constructive shareholder activism. Further, we look for a consistently produced strong tax-efficient return, low equity market correlation, and an attractive risk profile. As we practice the concentration of investing with high conviction, for the sake of mitigating risk, we also practice concentration risk, never taking the position of investing more than 10-15% in one stock. In all, we manage global long/short funds focused on developed markets as well as regionally concentrated long-only funds.

Q Describe your investment universe of old economy companies?

A We desire to expose ourselves to five or six unique core long holdings—an investment we intend to hold for a long period of time—which can comprise 60-70% of each of the portfolios. We boil this down further into potential "core" longs and also "other" longs. Core longs have investment-grade balance sheets, no commodity pricing dependency and low insider control, as we need there to be vulnerability to a takeover. We seek to own 2-7% of each core long holding and, as mentioned before, to have a close relationship with management. Overall, the potential universe of core holdings has around 170 companies in the U.S. (Quest Capital Partners, L.P.) and about 180 outside the U.S. (Rodinia Fund, Ltd.).

Since we require a reasonable turnaround to be in a cash position as well as low volatility, we have a min-max that we follow in relation to market capitalization. We do not look at a company below \$1 billion in

market cap or with a market cap over \$20 billion, given our need to have direct contact with management and to be a top-ten shareholder in our core holdings. We also exclude companies with idiosyncratic risk profiles which we consider unacceptable for a concentrated portfolio. These types of companies include high-tech and biotech companies with technological obsolescence risk, high product-liability risk companies, government regulated companies, and companies that lack sufficient financial and operational transparency, such as banks, brokerages and insurance companies.

Q What sets you apart from other managers?

A We are active shareholders that take the time to get to know the companies that we invest in very well. With a position of 10-15% of our capital in each of our core companies, it is imperative that we make our views clear, particularly with respect to capital allocation. For the most part, management appreciates the faith we're committing to their business and in them to get the stock out of the valuation trough. We believe activism has taken on a bit of a negative connotation in the past few years. Our brand of activism sets us apart from other managers in our style.

Other areas we feel that set us apart are the degree of concentration of capital and research with a limited number of core long positions with our funds, and the amount and intensity of fundamental research. Also, our investment/selection criteria and a highly disciplined, multi-category short strategy, featuring a combination of fundamental and technical timing disciplines, are unique in our sector.

Q What is your outlook and what is your strategy for generating expected returns?

A We see continued constructive equity markets in the U.S., Europe and Japan amid solid global growth, relatively low interest rates, manageable inflation and continued corporate profit growth. While each region has its issues (U.S.: weak housing; Japan: anemic consumer spending; Europe: regulatory obstacles), which may cause near term equity market weakness, overall valuations appear reasonable. The presence of shareholder activists and private equity is also a positive catalyst for improved corporate governance and operational excellence.

We are invested in quality companies with strong downside support (based on a low valuation multiple on highly predictable and sustainable cashflows) and 50% realistic upside potential in the next 12-18 month period. With our level of involvement as a shareholder, we seek to enhance and accelerate that upside potential.

Rodinia Fund and Quest Capital Partners were approved and added to Atlantic Trust Recommended List of Managers in December 2004 and June 2003, respectively. ■

Investment Review and Outlook

By Alfred F. Kugel
Chief Investment Strategist

Marking Time

Following the break-out into new record high ground during May, the U.S. stock market (as measured by the Standard & Poor's 500 Stock Index) then entered a period of consolidation that lasted throughout June at price levels modestly below the peak. Actually, considering the recent turmoil in the fixed-income markets, with longer-term interest rates jumping to their highest levels in some time, we consider that equities performed quite well to hold nearly all of their earlier gains. As a result, the S&P is showing a respectable total return of approximately 7% for the first half of 2007.

During the recently completed seven-year market cycle since 2000, stock prices first declined nearly in half from peak to trough during the 2½ year down phase in the aftermath of the high tech "bubble." This phase ended in October 2002, following which stock prices essentially doubled to climb back to their starting point during the ensuing 4½ years. Of course, although the level of the market has now recovered to its prior peak set back during the bubble in 2000, some things are much different now. Most importantly, corporate profits have risen sharply, so that earnings per share on the S&P 500 are nearly double what they were back then. At the same time, valuations are much more attractive, with the P/E multiple being about half as high as it was in 2000. As a result, the changes in these two factors have roughly offset,



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allowing the price to come out about equal. Moreover, today's interest rates and inflation are relatively low, and the amount of liquidity available in the global economy is unusually high.

Actually, the recent performance of stock prices since the minor low back in mid-March until early June was better than we expected. The trend during that period was pretty much straight up, with only a few minor day-to-day interruptions along the way. There are three reasons that can be cited for this upsurge: stronger than expected first quarter earnings, a surge in merger and acquisition activity and better economic news. Thus, after such a strong run, it is not surprising that the market is now pausing to catch its breath.

One of the supports for the recent rise in stock prices has been an upsurge in M & A activity, in which substantial premiums have been offered in order to take public companies private. This suggests that the valuations of stocks trading on the market are considered by some sophisticated investors still to be below normal. In addition, the latest economic data show that some of the key growth factors have come in stronger than expected, while core inflation numbers in the Producer and Consumer Price Indices came in lower than forecast.

Another event that aided investor sentiment was the adoption of a de facto "neutral" view of the interest rate outlook when the Federal Open Market Committee removed the wording from their statement that had been suggesting that "additional firming may be necessary." At this point, then, we believe that the monetary authorities are satisfied with the current policy stance and will keep short-term rates steady for some while ahead, awaiting additional data on inflation and economic growth to determine whether any change might be needed going forward.

Economic Slowdown Ending?

The U.S. economy has been in a "mid-cycle slowdown" with a period of slower than normal growth averaging about 2% annually since March of last year. Indeed, the last really strong period was the first quarter of 2006 when real GDP (helped by unusually mild weather) rose at an unsustainable 5.6% annual rate. Since then, the numbers have been 2.6%, 2.0%, 2.5% and 0.7%. (However, economic activity has re-accelerated during the second quarter of 2007, and our best guess is that growth in that period will be reported at around 3% or a little better.)

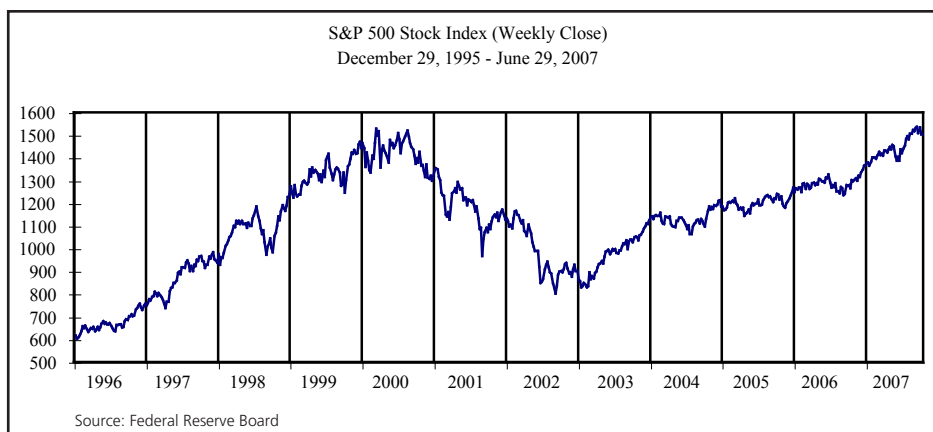
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Investment Review and Outlook

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What happened over this period, of course, is that the sharp decline in housing has acted as a drag, of around a full percentage point in each of the recent quarters but, aside from housing, the other sectors have continued to grow pretty much in line with their average potential rate of around 3%. Thus, assuming that housing bottoms out, even if there isn't much of a recovery in the months ahead, the economy as a whole should be able to rebound to a more normal growth rate around the end of the year or by sometime in early 2008.

The one other area of the economy that has been soft is sales of domestic nameplate automobiles. The rate of new car assemblies ran above the sales rate last fall, causing an increase in inventories on dealer lots. As a result, production was cut back to a level below sales in order to clear up the inventory oversupply. The most recent numbers suggest that this has now been done, and the assembly rate has been moved up more in line with deliveries. However, there is little evidence that would lead one to conclude that this sector of the economy will produce any meaningful growth, especially since the U.S. manufacturers continue to lose market share to the imports.



Sub-prime Mortgage Question

In recent years, especially 2005 and 2006, a large number of homes were purchased through the use of subprime mortgages. These instruments were often provided without calling for repayment of principal, with unusually low "teaser" interest rates, and without an adequate earnings history on the part of the borrower. In recent

months, an increasing portion of the subprime market has fallen into delinquency. Moreover, a number of complicated financial instruments have been issued based on these mortgages, producing more potential losses.

It is estimated that there are about \$1.25 trillion of subprime mortgages out of total residential mortgages of about \$10 trillion. If we assume that about a quarter of these, or some \$300 billion, go into default, the question is how large will the losses be. In general, we do not anticipate that the write-offs will be sufficient to adversely impact the financial system as a whole.

Stocks Multiples Still Moderate

As usual, corporate earnings are of major importance to the success of the market. Profits were very buoyant during 2006, rising by approximately 16% for the companies in the S&P 500. However, it is important to note that we believe the conditions that have produced four consecutive years of double-digit earnings growth are now behind us and, as a result, we are forecasting that earnings for 2007 will likely rise by single-digits, perhaps around 8%.

It is interesting to note that even though stock prices have increased substantially during the past several years—actually having risen by 94% since the October 2002 low—earnings have gone up even more. As a result, the 12 months forward earnings multiple has declined from about 18x at the end of 2003 to 15.5x currently. Overall, assuming that the investment environment remains

generally positive as we expect, reflecting the scenario described above, there would seem to be a reasonable chance of some upward revision in multiples during the next year or two, instead of a further decline. If so, this means that the market would provide even more favorable returns to equity investors. ■

Sources: United States Departments of Commerce and Labor, The Wall Street Journal, Bear Stearns, ISI Group and Citigroup

Technology Stocks: New Cycles, New Opportunities

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"Technology does have higher growth rates," he says. "A coordinated, long-term wealth preservation strategy should include growth to counter inflation's effects on a portfolio. In addition, unlike in the past, many technology stocks are now paying dividends, even though they're usually less than what the S&P 500 stocks pay. Microsoft, for example, caused quite a stir when it instituted a dividend in 2003."

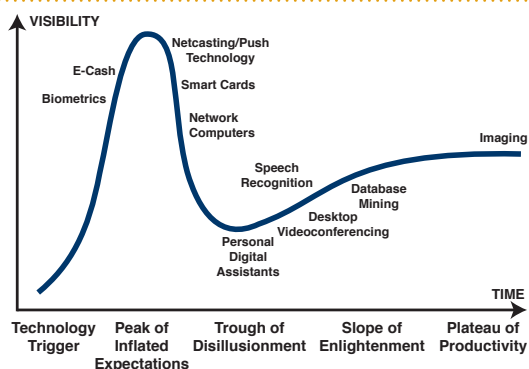
Typically, there are fifteen technology stocks, from various sectors, in Atlantic Trust's proprietary Core Growth Equity and five in the Equity Income offerings, but Jones tracks more than 100 companies on his radar screen. Some of the sectors that Jones likes are still in the early phase of their adoption cycle – the Internet, for example – while others, such as data storage, are further into maturity. Video over the Internet is growing rapidly and Voice over Internet Protocol (VoIP) is connecting customers worldwide for long distance rates of two cents a minute, becoming more pervasive by the month. Jones also is closely watching the solar power sector. "Material costs have now come down enough that solar energy is becoming a more economically viable alternative," he says. "Right now, you might be looking at a 15-year payback on the investment, but costs may come down 15 to 20% a year for the next three to five years, making a solar installation worthwhile. And from a corporate responsibility perspective, becoming a more 'green' company can earn you a lot of kudos and goodwill."

Boring, basic, but highly essential data storage is another sector with excellent growth prospects. Advances in such medical areas as DNA sequencing by extremely powerful computers is resulting in the need for additional storage, as is data related to oil and gas exploration, and the surge of new regulation in financial services requiring retention of emails and customer information. Of course, there's the large consumer electronics segment – just think of iPod's dominance and the iPhone's launch.

Cutting through the hype and determining the business model fundamentals that will result in good stocks for the Atlantic Trust portfolios is a big part of Jones' job – "I can't tell you how many times I've read a press release with the adjectives 'revolutionary' or 'profound' in it," he says. But there is some "science" to hype detection. In 1995, the Gartner Group, a highly respected research firm,

introduced the Gartner Hype Cycle. It describes the typical cycle of hype, disappointment, maturity, and adoption of new technologies—such as Linux® and Virtualization, two solutions now being widely deployed. One of the latest solutions going through the hype cycle is radio-frequency identification (RFID) tags used in supply chain management, which has powerful Wal-Mart behind it. Jones stated it has enormous potential, but despite Wal-Mart's big push it is still only in the early maturation stage of the hype cycle.

Hype Cycle Chart, www.gartner.com, 2006



Source: Gartner, Inc.

Whether it's recommendations to buy, hold, or sell (annual portfolio turnover is typically only about three to six stocks), Jones has to rely on only a small sliver of publicly-available information about a company – "maybe 5%," he says. "In addition to all the analytical skills, you really have to have a finely-tuned gut instinct for the 'truth' of what you're hearing and reading."

Parent Rebrands

We are pleased to announce the new name of Atlantic Trust's parent company, formerly known as AMVESCAP. Through shareholder vote at the Annual General Meeting on May 23, 2007, AMVESCAP's name was changed to **INVESCO PLC**. With \$491 billion in assets under management (as of May 31, 2007), 5,400 employees and offices in 19 countries, INVESCO PLC is one of the world's leading global investment managers (ticker symbol "IVZ"). Operating under the Atlantic Trust, AIM, INVESCO, AIM Trimark, PowerShares, WL Ross & Co. and INVESCO Perpetual brands, **INVESCO PLC** strives to deliver outstanding products and services through a comprehensive array of enduring investment solutions for our retail, institutional and private wealth management clients around the world.

As the INVESCO brand already has high respect, equity, synergy and momentum in the global marketplace, the change marks a powerful move toward our common purpose of *helping people worldwide to build their financial security.* ■

Summer is the Ideal Time to Take Stock of Old Trusts

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She was more than willing to do the one-time necessary paperwork to delegate those responsibilities to the corporate fiduciary.

Interests of current and future beneficiaries are at odds.

“Trusts that require trustees to pay all income to current beneficiaries and preserve principal for future ones, with no power to invade for current beneficiaries, can set one group against the other,” says Beerman. Lifetime beneficiaries generally want the largest possible payout, while future (remainder) beneficiaries prefer trust assets to increase in value. These trusts also inhibit trustees from investing for total return, which favors asset allocations that will produce the most growth over time, even if it means less current income.

State laws now provide ways for either beneficiaries or trustees to address the problem. The Uniform Principal and Income Act, adopted in most states, gives trustees the power to shift principal to income and income to principal if necessary to treat all beneficiaries fairly, even if that power is not in the trust document. There are yet other states with laws in place that permit permanent solutions.

Still, converting to a trust that is required to pay a specific amount can be very inflexible and may not preserve the inflation-adjusted value of the principal over the long term. Therefore, in old trusts that do not include the power to invade, whenever possible we prefer to rely on the trustee’s ability to exercise a power to adjust on a year-by-year basis under state law.

A periodic review, such as during summer vacations, of old trusts can keep past goals on course and greatly

enhance future planning. Wealth strategists at Atlantic Trust can analyze existing trusts, prepare flow charts for beneficiaries, and help coordinate new trusts with the rest of your estate plan, so that you are still on track to fulfilling your objectives.

Planning with New Trusts

Some of the problems we have seen arise with old trusts can be avoided with new ones by making the trust as flexible as possible. Judith A. Saxe, managing director at Atlantic Trust, recommends the following steps, which can help a trust adapt to changing circumstances:

- ✓ Rather than requiring payouts at specific ages—such as income to beneficiaries in their 20s and distributions of principal staggered at ages 30, 35 and 40—give the trustee broad discretion to decide when to make distributions of income and principal. The trustee can make this decision based on factors you include in the trust document or in a side letter.
- ✓ Choose trustees who are strongly qualified to play the role you assign to them, whether it is making decisions about distributions, or investing the assets. (For more information, request a copy of the Atlantic Trust Wealth Strategies White Paper, “Choosing a Trustee.”)
- ✓ Give trustees in charge of distributions the power to invade principal for a limited purpose, such as health, education, maintenance and support, to treat all beneficiaries fairly during the term of the trust.
- ✓ Devote as much thought to designating successor trustees, or designing a mechanism for appointing them, as you do to selecting the initial ones.
- ✓ In addition to naming trustees, appoint a *trust protector* (sometimes called a *special trustee* or *trust advisor*). This is an independent party who can make certain key decisions or adapt various trust terms as circumstances change. Examples include the power to: add or delete beneficiaries within a family, remove and replace trustees, accelerate payments of principal, and direct investment decisions. ■

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