

2011

March 9

ASSET ALLOCATION UPDATE

From the Desk of Our Chief Investment Officer

The late February meeting of the Atlantic Trust Asset Allocation Committee (AAC) focused on two important topics, one overseas and one at home.

Inflation in the Emerging Markets

Emerging market (EM) equities have been star performers over the last decade. However, these stocks have lagged in recent months. A major factor in this short-term underperformance has been rising inflation in several fast-growing developing economies. As seen in the charts on page 2, inflation rates in China, India and Brazil have all accelerated. Monetary authorities have been hard at work to combat the uptick in inflation, and therein lies the concern for many investors.

China provides an instructive example of how inflation-fighting policies can spook equity investors. For the past several years, China has been the world's growth engine, posting a GDP growth rate over three times that of the U.S. But hyper-growth often comes with the risk of imbalances. In addition to higher inflation, China has experienced rapidly rising property prices in large urban areas and breathtaking expansion of bank lending. Policymakers have stepped in to cool the economy's frenetic pace to avoid an inflationary spiral. Over the past year, the central bank has raised interest rates and bank reserve requirements several times. The government has imposed a variety of restrictions on mortgage borrowing and taken other measures to discourage real estate speculation. These policies are all prudent, but they have taken a toll on Chinese stock prices as investors worry about the authorities getting too much of what they wish for – in other words, a painful slowdown in the economy rather than gentle deceleration. Variants of the Chinese story are playing out in India, Brazil and several other developing nations.

Atlantic Trust has long advocated emerging markets equity exposure. At the bottom of the bear market in early 2009 we recommended increasing EM, and we did so again later that year and in early 2010. The AAC's positive view on commodities has also been largely driven by rising demand from EM economies, and we built an EM debt recommendation into our model portfolios in 2009. Clearly, we are long-term believers in the secular benefits of investing in the strong growth and structural improvement themes in these nations.

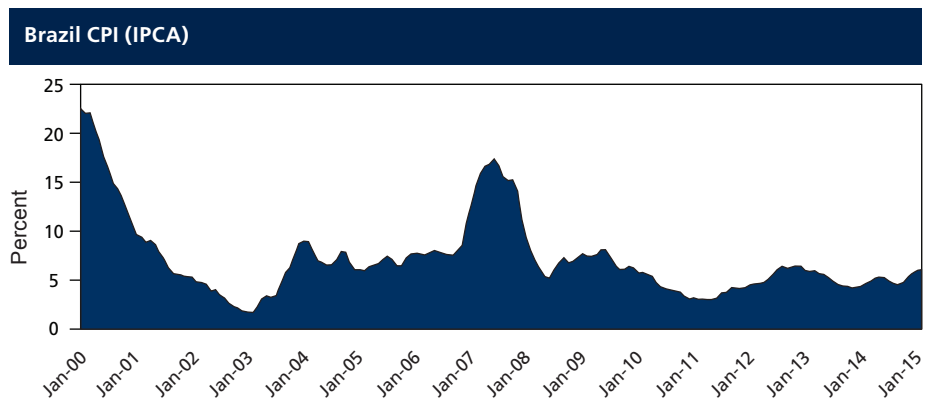
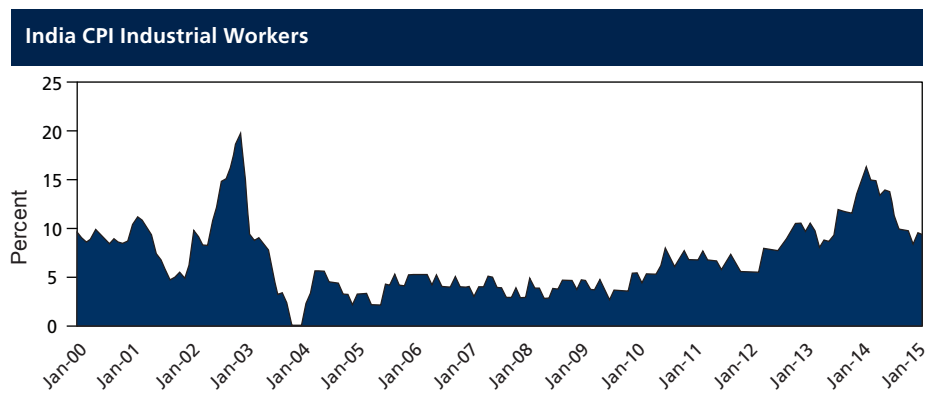
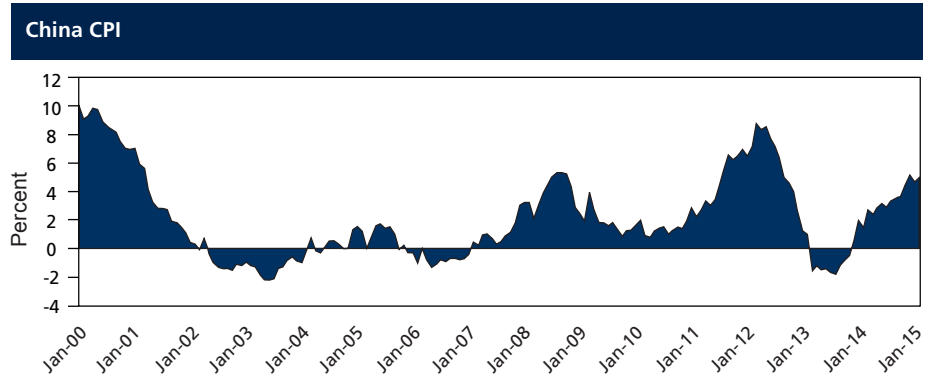
David L. Donabedian *Chief Investment Officer*

Dave Donabedian is chief investment officer of Atlantic Trust, returning to the firm in 2009 after serving as chief investment officer for Ashbridge Investment Management, LLC from 2006 to 2009. As a leading investment expert in our industry, Dave frequently appears on television networks, such as *CNBC*, and provides insights in publications, such as *Barron's*. Previously, from 1996 to 2006, Dave worked with Atlantic Trust as managing director and chief economist. Dave received a B.S. in economics and a B.A. with honors from The Wharton School at the University of Pennsylvania. He subsequently earned an M.B.A. from Columbia University Graduate School of Business.

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Given recent underperformance and policy challenges described above, the Committee wrestled with the tactical challenges posed by monetary tightening. In other words, is this a buying opportunity or a good time to book some of the long-term profits? We continue to believe strongly that participating in the secular EM growth story will be a critical factor in generating portfolio appreciation over the years. Thus, the AAC was not inclined to reduce positions in our asset allocation models. At the same time, it was deemed premature to add to positions. As we have learned in the U.S. over the years, monetary tightening cycles sometimes can have unexpectedly harsh consequences. So, short-term, risk in these markets is at least slightly elevated.



Source for Above Charts: Bloomberg, December 2010. Data after December 2010 is estimated.

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We will continue to follow events in the EM closely, with an admitted bias toward looking for an opportune situation to add to positions at lower risk-adjusted valuations. Our hunch is that a good part of the EM inflation scare would recede when spring and summer planting conditions improve and relieve a variety of crop supply shortages or if tensions in the Middle East/North Africa subside and remove the supply risk

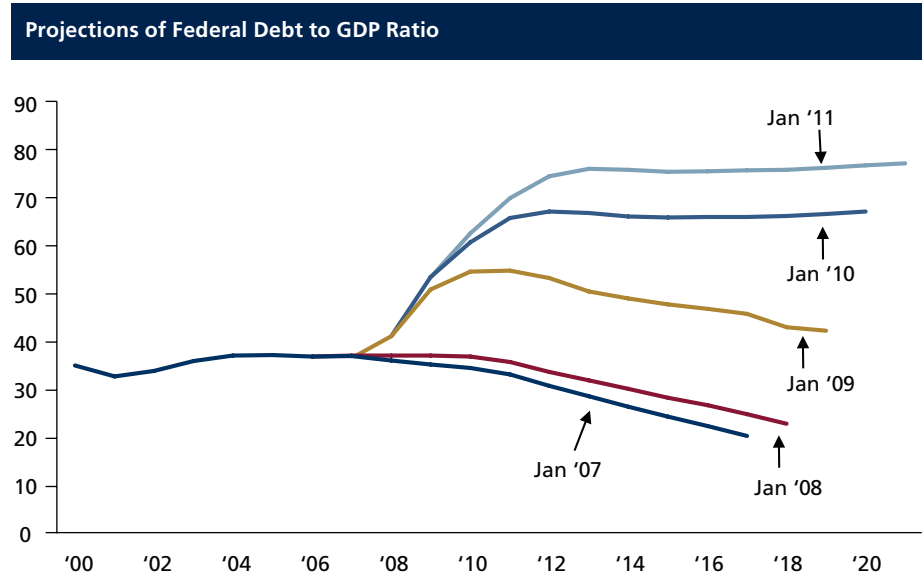
premium currently embedded in oil prices. Meanwhile, we encourage qualified investors to consider hedged strategies in the emerging Asian markets. The scenario described has increased short-term macro risk. Yet, hedged opportunities focused on specific investments in Asia while limiting market volatility are an appealing combination. Please speak with your relationship manager if you would like more information.

The War at Home: Goodbye Stimulus, Hello Austerity

After three years of massive government spending – first to prevent financial collapse, and then to boost a depressed economy – the tide has turned. The impact of the 2010 election results, dreadful budget deficit problems and slightly more optimism about the U.S. economic outlook have shifted the “stimulus at any cost” mentality to a far more sober budget-cutting focus.

The rapid deterioration of the federal government’s balance sheet is illustrated below. It paints a disturbing picture of a gathering debt storm. It shows annual debt to GDP ratios forecasted by the Congressional Budget Office (CBO) for the last five years. For example, four years ago, the CBO projected that the debt/GDP ratio would be about 20% in 2017. There was progressively bad news with each annual forecast, and the most recent projection for 2017 is nearly 80%.

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Source: Congressional Budget Office, January 2011. Data after January 2011 is estimated.

The new Congress, with a change of party leadership in the House of Representatives and an influx of members in both chambers who feel their mandate is to control spending, have changed the terms of the debate to how much – and what – to cut. A more zealous effort is occurring at the state level, where governors and legislatures are constitutionally required to balance their budgets.

The AAC addressed this important priority shift from the perspective of its implications for the U.S. stock and bond markets. At the federal level, meaningful deficit reduction is essential to the long-term underpinnings of the economy and financial markets. There is well-documented history supporting skepticism on whether politicians will seriously address the federal debt problem. However, the House’s quick approval of \$61 billion in cuts to the current year’s budget is an initial salvo in the direction of potentially meaningful deficit reduction in future years. It is the sense of our Committee that financial markets are underestimating the potential for a material deficit reduction plan to unfold in the months ahead. Are the odds of a big, bold deficit reduction package passing any time soon above 50%? Certainly not. But we think

there is a better than negligible chance, and we are intrigued that consensus expectations on this issue are for nothing but token action.

What would be the reaction in financial markets to a deficit reduction “surprise” out of Washington? The answer is clearer for bonds than stocks, but we believe both would rally. An improved deficit outlook would relieve Treasury supply fears as well as debt-inspired inflation worries. Austerity measures could slow GDP growth and corporate earnings in the short-term – normally a negative for equity markets. In fact, Atlantic Trust’s economic forecast already anticipates slower growth later this year and in 2012, due in part to the fading of stimulus programs. However, the AAC believes that the short-term concerns would be overwhelmed by a favorable reaction to progress on the issue that both institutional and individual investors have long regarded as the greatest long-term risk to our nation’s prosperity.

The very emotional austerity debate going on in many states has implications for the municipal bond market. Aggressive attempts by elected officials to rein in spending on state and local employees produced an epic battle surrounding the cost of government versus the rights of unionized public workers. Wisconsin has been the focal point of the battle, though similar measures are being considered in several states. It is unclear at this writing how the Wisconsin standoff will be resolved. But it is an example of our fundamental point that the terms of the budget debate have shifted toward budget cutting. In a sense, the unions in Wisconsin have already lost as they have publicly agreed to wage freezes and an increase in worker contributions to health care and retirement plans. The end result will be a rollback in taxpayer-subsidized employee benefits and future state funding liabilities. Without taking sides in the ideological battle that has broken out in Wisconsin and elsewhere, we view material spending curbs as helpful in settling the intermittent jitters that have afflicted the municipal bond market in recent months.

As always, the most important asset allocation discussion is between you and your relationship manager. While the Asset Allocation Committee works hard to identify general opportunities for return enhancement and risk reduction, every client portfolio is managed to address customized objectives. Therefore, some of the recommendations referenced above may not be appropriate for your specific situation, so please speak with your relationship manager.

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