

ASSET ALLOCATION UPDATE

From the Desk of Our Chief Investment Officer

David L. Donabedian, CFA
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 *Baron'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.

“Roll out those lazy, hazy, crazy days of summer...”

The lighthearted spirit of Nat King Cole’s classic was not much in evidence this summer, but he certainly got the crazy part right. Global equity prices fell at accelerating rates in June, July and August while money flowed into safe havens such as U.S. Treasuries and gold. Politicians and policymakers in the U.S. and Europe—usually out of the limelight and on vacation over the summer—were all too present on both continents, dealing with fiscal crises that were major catalysts for financial markets’ volatility. Meanwhile, economic news pointed to a distinct slowing in the global recovery, with rising recession risk in the U.S. and Europe. As seen in the chart below, after a powerful rally from the depths of the 2008-2009 bear market, risk assets corrected over the most recent three-month period.

Recovery...and Correction

	Total Return	
	3/9/09–5/31/11	6/1/11–8/31/11
S&P 500 Index	106%	-8.9%
Russell 2000 Index (Small Cap)	151%	-14.0%
MSCI EAFE Index (Developed Country Int'l)	104%	-11.5%
MSCI Emerging Markets Index	143%	-10.6%
Dow Jones-UBS Commodity Index	59%	-1.3%
Barclays High Yield Bond Index	96%	-3.8%
Barclays U.S. Investment Grade Corporate Bond Index	35%	1.7%

Source: Bloomberg L.P., as of 08/31/2011. For index descriptions, see page 4.

Domestic View: Problems Galore, Take Refuge in Quality

The parallels between this summer and the summer of 2010 are almost eerie. In both years, equity prices peaked in late April, and then corrected more than 15% over the ensuing three months. In both years, volatility spiked to nearly identical levels not seen since the Lehman bankruptcy crisis. The underlying catalysts were the same, too: a European sovereign debt crisis, a double-dip recession scare in the U.S. and a material decline in investor and consumer confidence.

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Last year, Fed Chairman Bernanke's speech in late August provided the elixir for the market's blues as he foreshadowed what came to be called "QE2." This strategy of expanding the Fed's balance sheet (i.e., printing money) sparked a powerful nine-month rally in risk assets such as stocks and commodities. Not surprisingly, there was great anticipation of Bernanke's late August speech at the same Jackson Hole venue this year. The same negative forces had conspired to hit the stock market and economy—maybe a turnaround could be sparked by the same source as well?

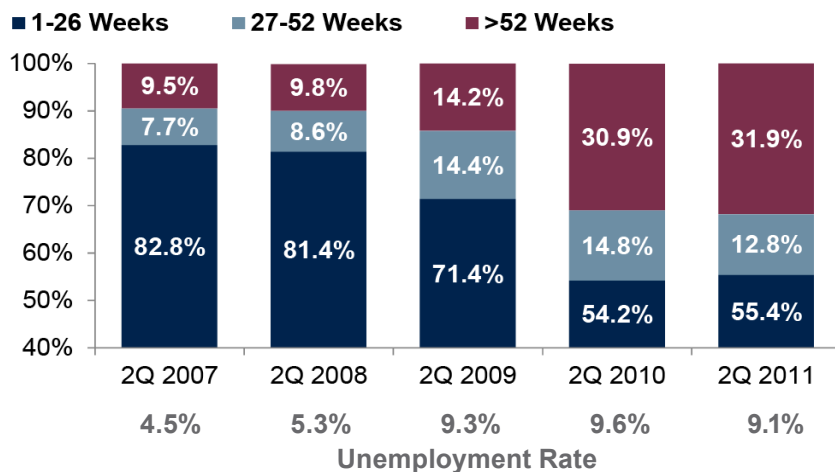
While Bernanke's speech has been generally well received by markets, it is unlikely to produce a surge in asset prices anywhere near what transpired last year. The 2011 version of his speech was far less specific on policy prescriptions—just a soothing message that the Fed stood ready to act if necessary. When QE2 was hatched, a major rationale was that it would boost the sagging economy. The evidence is in, and it failed on that front. Thus, even if the Fed were to roll out QE3, there would be skepticism about its ability to have a lasting positive impact on economic growth. Indeed, the chairman went out of his way to say "Most of the economic policies that support robust economic growth...are outside the province of the central bank."

Skepticism about monetary policy's ability to boost the economy and markets pales in comparison with assessment of fiscal policy. Last year's expectation of a "change election" that would shake up the political structure was another catalyst for the market surge in late 2010. That change has become reality, but so far has served to depress (in all meanings of the word) consumers, businesses, the overall economy, investors and equity prices. The debt ceiling debate, while ultimately skirting default and even producing a modest deficit reduction plan, was the poster child for the old adage that it is best not to see how laws or sausages are made.

The Atlantic Trust Asset Allocation Committee's (AAC) operating assumption on the economy is that a recession is unlikely, but that the U.S. remains stuck in a slow growth channel for the foreseeable future. This is due to the debt-induced nature of the economy's struggles. A seminal study on financial crises found that it takes about four years for an economy just to get back to its pre-crisis level of national income.¹ It also confirms what we are experiencing—fiscal and monetary policies are of limited value in speeding the recovery process. The job market is a key example of the protracted nature of the recession and the subsequent wobbly recovery. Not only is the unemployment rate stuck at high levels, but almost one-third of the unemployed have been out of work for more than a year.

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Share of Unemployed by Weeks Out of Work (2nd Quarter, 2007-2011)



¹This Time is Different: Eight Centuries of Financial Folly, Carmen M. Reinhart & Kenneth S. Rogoff, 2009.

Source: Strategas, Bureau of Labor Statistics, as of 06/30/2011

We are cautiously optimistic about finishing the year in positive territory. Our recommendation heavily weights large, multi-national companies with global revenue sources and strong balance sheets.

We began the year with a forecast of very slow economic growth, continued low interest rates and a “mid-to-high single-digit” rise in the stock market. The first two have materialized, while the stock market has slipped into negative territory after the summer selloff. Despite our skepticism on the economic and policy outlooks, the AAC believes that high-quality U.S. stocks are inexpensively valued and retain decent earnings power in the months ahead. We are cautiously optimistic about finishing the year in positive territory. Our recommendation heavily weights large, multi-national companies with global revenue sources and strong balance sheets. We also maintain our view that equity income strategies emphasizing high dividend streams are attractive.

International View: Reduce Exposure to Europe

In early August, the AAC recommended reduced exposure to the Developed International equity markets due to rising systemic risks in Europe. Signs of systemic risk, as opposed to more conventional cyclical or valuation risks, emerged largely due to the links between sovereign debt and the banking system in Europe. Many large European banks own vast amounts of debt issued by Eurozone governments. Rising risk levels in the bond markets of large economies like Italy (see chart below) and Spain raised the specter of weakening the balance sheets of undercapitalized European banks. As we found out in the U.S. in 2008, these circumstances can have unexpectedly severe consequences. Furthermore, this most recent sovereign debt crisis seems to have slowed the German economy, which had been the Continent’s growth engine for the past two years. Thus, the AAC thought it prudent to pull back on managers with substantial European equity exposure.

Cost of Insuring Against Italian Sovereign Debt Default



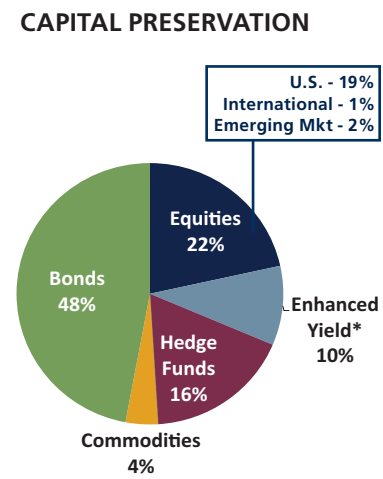
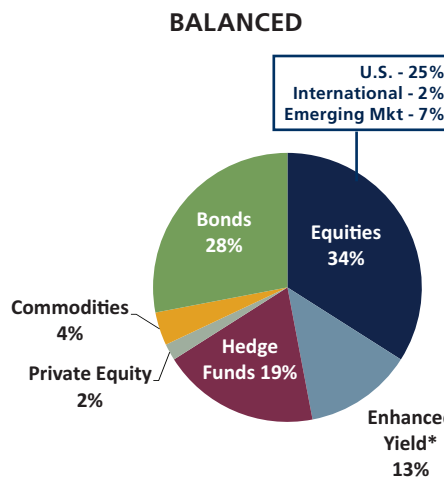
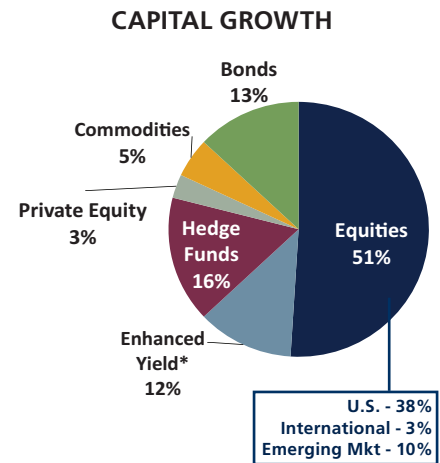
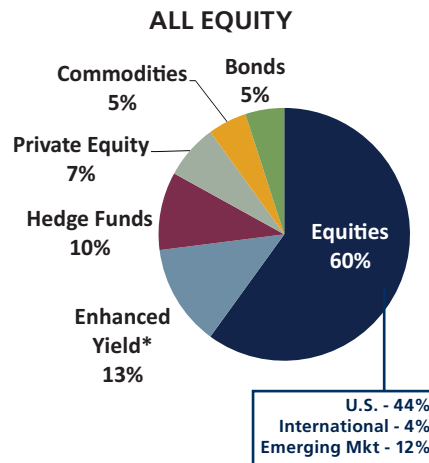
Source: Bloomberg L.P., as of 09/02/2011

Our emphasis continues to lie with the emerging equity markets. While many of these countries currently suffer from cyclical challenges related to inflation, these are temporary and more “fixable” in nature than the structural headwinds facing the U.S., Europe and Japan.

As you can see on page 4, **hedge funds form an important part of our allocation recommendations.** Volatility is likely to remain high, and well-managed hedged strategies can seize upon individual or thematic opportunities while shielding exposure from the ups and downs of the market averages.

As always, the most important asset allocation discussion is between you and your relationship manager. While the Atlantic Trust 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 previously referenced, and the asset allocation models illustrated to the right, may not be appropriate for your specific situation, so please speak with your Atlantic Trust relationship manager.

Asset Allocation Committee Model Recommendations



*Enhanced yield includes Master Limited Partnerships (MLPs), equity income, emerging market debt and floating rate senior debt. Source: Atlantic Trust, 08/31/2011

Index descriptions for "Recovery and Correction" table (page 1): The S&P 500 Index, a market value weighted index, consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 index. The MSCI EAFE Index is a free float-adjusted market capitalization index designed to developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The Dow Jones-UBS Commodity Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The Barclays Capital High Yield Index includes publicly issued U.S. dollar denominated, noninvestment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year. The Barclays Capital U.S. Investment Grade Bond Index measures the performance of the investment grade corporate bond market.

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