The Atlantic Trust Advisor

Health Care Reform

2009 is seen as a watershed moment for potential health care reform. Democrats control the White House and Congress, business groups and employers are advocating for changes, and some special interest groups are starting to work toward compromises and negotiations. Fred Weiss, a senior investment expert who leads the research efforts of Atlantic Trust's investment team, presents the following analysis.

Frederick L. Weiss, CFA
Managing Director

Also in this issue:

Parsing the Proposals

Health care is the headline issue for the current session of Congress. If a bill doesn't get passed by the end of 2009, chances are the issue may wither on the vine. Public support for reform is already becoming shaky, and elections will demand energy and attention in 2010.

So, now is the time to study up on the issue.

The Problem

The broad idea of health care reform is to resolve two main problems.

- **Cost.** In 2008, health care spending in the U.S. was $2.4 trillion, or 17% of the gross domestic product (GDP). To put that in perspective, the U.S. spends 4.3 times more on health care than it does on national defense.[1] And the costs are growing. By 2017, health care spending is projected to account for 20% of GDP. This represents an increasing burden on businesses, the government and individuals.[1]

- **Coverage.** Despite the staggering amount of money spent on U.S. health care, about 47 million people are uninsured. Nearly one-third of those are people who could afford coverage, but choose not to carry insurance. One-third qualify for Medicaid but simply haven't signed up for it. And the final third are the working poor, who do not qualify for Medicaid but cannot afford coverage.[1]

Additionally, there is a range of smaller issues at work – from patent issues for

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Health Care Reform

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biotech products, to doctors' Medicare reimbursements, to electronic record-keeping for patients' health files.

The Politics

Due to the scope and complexity of health care, reforms are always extremely tough to accomplish. States, doctors, hospitals, pharmaceutical companies, insurance companies and employers all have a stake in the results. And those who have health care coverage — whether from Medicare or employer-provided plans — worry about the effects that reform will have on the quality, cost and availability of their health care.

2009, however, is seen as a watershed moment for potential reform. Democrats control the White House and Congress. And, unlike during President Clinton's term, business groups and employers are advocating for changes, due to soaring costs. Some special interest groups that have fought change in the past are working toward compromises and negotiations.

That said, certain hot-button issues slowed progress during the first half of this year.

- **The "government plan."** Many Democrats want to establish a public insurance plan that would compete with private plans. But Republicans counter that a public plan would weaken — and eventually eliminate — private plans. This, they worry, would leave the federal government in sole control of the health care system.

- **Costs.** The costs of the various bills under consideration are enormous, hitting close to $1 trillion over 10 years. Debate has escalated over the tax burden associated with these plans; i.e., which taxes will be raised, and by how much? This debate has crossed party lines, with a coalition of "Blue Dog Democrats" siding with Republicans in opposition against certain high-cost provisions.

The Possibilities

In our view, a viable bill still has a chance to emerge during the next six months, but it will be a watered-down bill designed for maximum political coverage.

We believe compromises will have to be made regarding the government plan to alleviate fears that it will compete unfairly with private plans — resulting in a "government-lite" plan. Shades of concession were seen in late July, when the House reached a compromise that said the public plan should negotiate rates with health care providers, as private plans do, rather than use the Medicare fee schedule, which would force providers to accept below-market rates.[2]

Compromises will also have to be made regarding costs and the taxes needed to pay for them. Much of the House debate has focused on a surtax on wealthy individuals, while the Senate has discussed taxing the "most generous" employer-provided health insurance plans.[3]

The Path Ahead

Once the House and Senate pass their bills (summarized below), a House/Senate conference committee reconciles changes between them. Then, the new compromise bill has to pass both the House and Senate before going to President Obama for his signature.

Atlantic Trust is keeping a close eye on Congress, and we will provide updates as the situation progresses. ■

The Bills

	House Bill	Senate Finance Committee Bill	Senate Health, Labor, Energy and Pension Committee Bill
Who's behind the bill?	Three committees are working together: Education and Labor, Energy and Commerce, and Ways and Means	The Senate Finance Committee, headed by Democratic Senator Max Baucus	The Senate Health, Labor, Energy and Pension Committee, led by Democratic Senator Tom Harkin
Does the bill include a government-run public plan?	Yes	No. Details are still being worked out, but the bill may include a system of consumer-owned cooperative plans with government funding	Yes
What would the bill cost?	Under $1 trillion over 10 years[4]	Close to $900 billion over 10 years; however, key issues are still being debated[5]	Less than $615 billion over 10 years[6]
Where does the bill stand as of the September recess?	Approved by the committees	Ammendments are under review	Approved by the committee

1 *Wellpoint BMO Capital Markets Focus on Health Care Conference, August 5, 2009*
2 *National Coalition on Health Care*
3 New York Times, *House Democrats End Impasse on Health Bill, July 30, 2009*
4 New York Times, *Topics: Health Care Reform*
5 New York Times, *Senator Sees 'Good News' in Cost Estimate on Compromise Health Bill, July 29, 2009*
6 *help.senate.gov, press release, July 15, 2009*

A TEAM FOR ALL SEASONS

When are 15 heads better than one?

There's an old adage that to get something done, a committee should consist of no more than three people, two of whom are absent. But since 1999, when the Asset Allocation Committee (AAC) was first formed, that old adage has been disproven. Performance records of the AAC's recommendations clearly demonstrate Atlantic Trust's historical ability to add value through "heads together" asset allocation recommendations. (To review the AAC's record, please contact your Atlantic Trust Advisor.)

Meeting monthly, the 15 senior investment professionals of the AAC focus on Atlantic Trust's hierarchy of objectives:

1. Capital Preservation
2. Maintaining Purchasing Power vs. Inflation
3. Growth Through Solid Risk-Adjusted Returns

These objectives are melded with each client's unique requirements, such as liquidity and income, time horizon, taxes, return expectation, risk tolerance and any other specific portfolio constraints. Layered over strategic asset allocation are tactical recommendations that must clear a high hurdle. "If we're going to make tactical changes, they must add value to a portfolio," says Dave Donabedian, CFA, chief investment officer. "We have to identify a material mispricing in the market that will allow us to re-allocate to either reduce risk or generate more return. Tax considerations and transaction costs are factored in, and the time horizon for our tactical recommendations is 12 to 18 months. We're seeking opportunities that are significant and sustainable – well beyond what is often referred to as market timing."

A Decade of Change

While the asset allocation philosophy hasn't changed since the AAC was formed in 1999, the process has had to change to respond to an investment world that is more global and more complicated. In the past decade, we've experienced two bear markets – the most recent, of record-breaking proportions – major geopolitical events, a proliferation of new and complex financial products, and heightened interest from high net worth investors for hedge funds and other alternative investments previously the exclusive province of institutions. Quite simply, says Donabedian, "There are more moving parts to consider. We have to be more nimble and more open-minded to take them into consideration."

Few periods have both tested the skills and validated the Committee's purpose like the past 18 months. Becoming more nimble, and moving quickly but thoughtfully, came into sharp relief in September 2008, when major financial institutions fell into crisis, the market began its meltdown and the economy seemed near collapse. The AAC held to its monthly meetings but had daily discussions among members about rapidly changing developments that needed intensive research and analysis. "Quite frankly, we had to develop positions on events that weren't typically on our radar," says Gary Pzegeo, CFA, managing director and head of fixed income. "It's one thing to be on top of normal cyclical events, but suddenly we were faced with highly unusual developments we hadn't seen before – traditionally 'safe' and liquid instruments, for example, caught in a market-wide credit freeze. We had only 70-year-old 'textbook' references to anything similar."

Fundamental quantitative tools failed everybody, points out Doug Rogers, CFA, managing director. "Late 2008 and into 2009 was truly an 'outlier' event," says Rogers. "An important element we added to the Committee's work was applying an understanding of behavioral finance, considerations that aren't easily captured by models and data. Negative sentiment was driving the market. Our job was making sure we had the capital preservation core intact and continually examining whether the fundamentals for staying exposed to the market were still there. We had to peel away the quantitative measures and think more about the psychology driving markets."

Looking for Alternatives

The Committee began to focus on alternative investments as a tactical change to portfolios. Recommendations to increase investments in non-correlated assets such as hedge funds and private equity resulted from careful scrutiny and lengthy deliberations. The Committee had begun researching and studying commodities as far back as early 2007, but was concerned with commodities' valuations – oil, for example, was on its way to $150 a barrel and other commodity prices were heading up – and only made its recommendation for an increase in February 2009, when the outlook for commodities was more attractive. A recommendation to a higher allocation into high-yield bonds and emerging markets also joined the mix. These tactical decisions have paid off. "More of the value we added to clients' portfolios this year came from an increase in alternative investments," says Rogers. "For all of our model portfolios, opportunistic assets with low correlations to long only equities now account for at least 30% of the target. We'll continue these opportunistic tactics."

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A TEAM FOR ALL SEASONS

When are 15 heads better than one?

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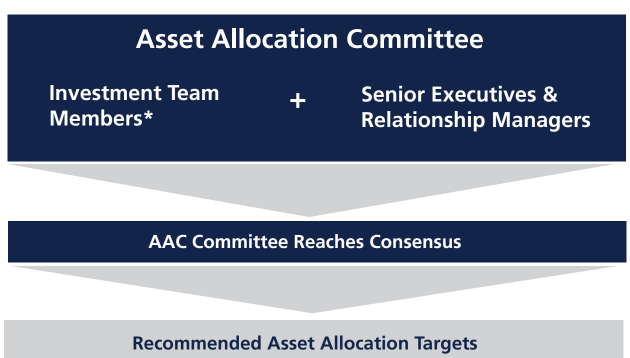
The People and the Process

Clients, says Mark Powell, managing director of the Austin office, understand and appreciate the Committee's thinking. Throughout 2008 and 2009, communications "on the front line" were a primary focus of each Atlantic Trust office. "Because each office has a representative on the Committee, clients feel like they have access to a very important part of the firm," says Powell. "We may not get every call right, but they understand when we explain why the Committee has made changes in portfolio recommendations. Our clients are smart and sophisticated and they have seen what's gone on in the economy and the markets this year. I believe they really value the thinking and the 'digging' we do, the exploring within the bounds of prudence."

When crisis mode hits, it's tempting to crawl under a rock and wait it out. "It's very difficult to look into the teeth of an unprecedented set of economic conditions and say, 'Where should we be stepping up?' It requires leaning against human nature," says Donabedian. "The Committee has taken the approach that things have been tough, but there will be a recovery and there will be reflation, and we need to make sure clients are positioned for that."

Atlantic Trust's Asset Allocation Process



* For a list of Investment Team Members, please see 400+ Years of Knowledge in the right column.

Prior to each meeting, the four AAC sub-committees (domestic equity, domestic fixed income, international and alternatives) review data, discuss what's happening in markets and bring a consolidated view to the meeting. They examine economic data points, long-term business trends, political developments, corporate earnings and observations from the Federal Open Market Committee. During volatile market periods, such as 2009, the AAC is more likely to recommend adjustments to model portfolios, as it has done in each month (through August) this year. The recovery, or what may be passing for one, is the subject of the AAC's current work. The S&P 500 had an extraordinary rally in less than six months – a total return of 52.6% from the March 9 low through August 31[1] – news on both the earnings and the economic front was more upbeat in August, and third quarter GDP will likely be quite strong. But a healthy level of skepticism remains. "We're continually thinking about hybrid models we can apply to our asset allocation," says Pzegeo. "It requires more study – and more intuition."

And a reminder of another old, and often dangerous, adage in investing: "Too many times, we've heard the phrase 'this time is different,'" says Donabedian. "Sometimes it really is different. This has been one of those times. When it is, we have to remember that textbooks and historical models may not be the best preparation. That's when we rely on the experience of the team." ■

1 Bloomberg.com

400+ Years of Knowledge

The Asset Allocation Committee (AAC) meets monthly to assess the macroeconomic and investment environment, identify risks and opportunities in the financial markets, set asset allocation guidelines and communicate both internally and externally the firm's asset allocation guidance. Managers throughout the firm rely on the AAC's guidance in formulating the initial asset allocation for each client. The AAC's recommendations are used to adjust client asset allocations as needed.

The AAC is made up of 15 senior investment professionals, including:

Dave Donabedian, CFA, Chief Investment Officer
23 years of experience

Al Kugel, CFA, Chief Investment Strategist
56 years of experience

Alan Fields, Chairman of the Multi-Manager Investment Committee
45 years of experience

Gary Pzegeo, CFA, Head of Fixed Income
20 years of experience

Douglas Rogers, CFA, Co-Manager of Equity Income Strategy
16 years of experience

The other 10 members are managing directors and senior relationship managers with 25 years of experience on average, representing Atlantic Trust offices around the U.S. Collectively, the AAC has 408 years of experience in investment management.

It's Not Just About Harvard Anymore

A Discussion with the Multi-Manager Alternatives Team

V. Paul Lisanke, CAIA
Senior Vice President

Jigar Patel, CFA
Senior Vice President

Headlines notwithstanding, the "endowment model" is still a strong strategy for portfolio diversification and long-term returns.

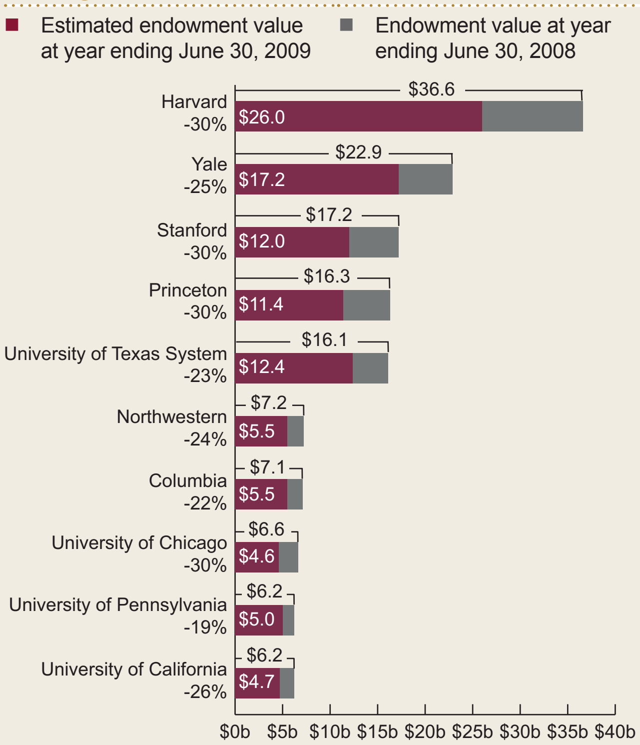
Just two years ago, the "endowment model" was making headlines for the successes of some of its early adopters of alternative investments as a sizeable part of a portfolio. Almost non-existent less than 20 years ago (alternatives made up only 5% of endowments' portfolios in 1991), hedge funds, private equity, venture capital and private real estate took a prominent position in the 2000s. At the end of fiscal year 2008, the Yale University endowment, led by David Swenson, had an average annualized gain of 16.3% for the previous 10 years.[1] Before he left Harvard in 2005, Jack Meyer had a 10-year run of a 15.9% annual return to the endowment portfolio.[2] Seeking an investment mix to meet endowments' payout requirement of 4 to 5% annually, and copied by foundations, affluent investors and family offices, it was a strategy that worked – until it didn't.

More recently, the headlines have been as notable, but less pleasant. Harvard's endowment lost 27.3%, or $10 billion, in its fiscal year ending June 30, while Yale had a 30% loss.[1] A survey of foundations and endowments with assets of more than $1 billion by Wilshire Trust Universe Comparison Service showed an average decline of 17% in fiscal 2009.[1] As losses were projected throughout 2009, another headline emerged: Are the endowment model and its hefty allocation to alternatives broken?

"The answer is a firm no," says Paul Lisanke, senior vice president in Atlantic Trust's Multi-Manager Investment Team. "It's worth noting that, despite Harvard's big recent loss, the endowment was up 8.9% annually over the last 10 fiscal years. But it's very important to understand the context of these losses. While hedge funds overall were down about 20% in 2008, the S&P 500 was down 37%.[3] One of the biggest reasons these well-known endowments lost so much was that their allocation to alternatives was, in many cases, tilted too heavily toward the highly illiquid alternatives such as private equity and private real estate funds, which typically have a 10-year lock. And hedge fund losses resulted from a controversial September 2008 ruling by the SEC banning the short sale of stocks, use of too much leverage by many funds and problems with counter-party risk evidenced by failed institutions such as Lehman Brothers and AIG.

In short, these endowments had far too little liquidity. While endowments greater than $1 billion had, on average, 41% allocated to alternative investments, they had only 1.4% cash and 10% bonds.[4] Harvard even entered 2009 with a negative 3% cash in its portfolio. "During a financial setback, whether for an institution or an individual, cash and liquidity are imperative," says Jigar Patel, senior vice president. "With that as a fundamental criterion, the endowment model is still very attractive."

Top Endowments' Projected Losses for Fiscal Year Ending June 30, 2009



Source: 2008 endowment figures are provided by the 2008 National Association of College and University Business Officers study. The projected 2009 data is FundFire calculations of each school's projected and actual losses, reported in various school documents, in comparison to the NACUBO data.

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It's Not Just About Harvard Anymore

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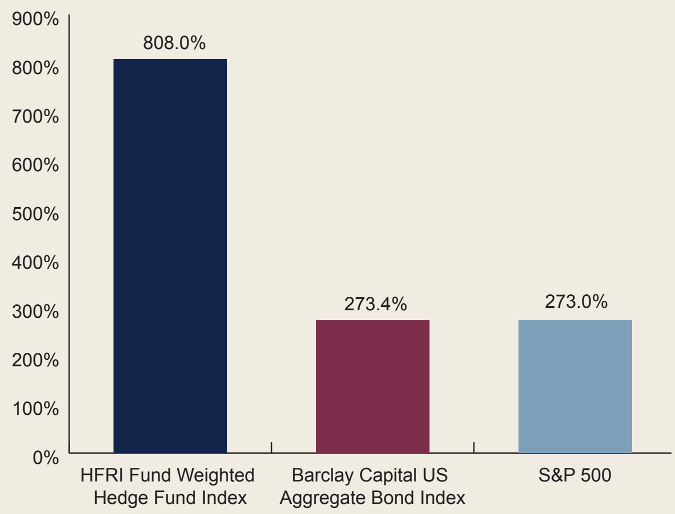
The New Endowment Model

As endowments and other institutional investors plan the way forward, they may be considering an emerging allocation framework that relies more heavily on "liquid alpha," or opportunistic, hedge fund investments, with a smaller allocation to illiquid hedge funds and investments in private equity, real estate and natural resources. Indeed, the case for hedge funds in general is still strong, as shown in the chart below that compares the returns of a hedge fund index with a taxable bond index and the S&P 500.

Role of Hedge Fund Investments in a Traditional Portfolio

Historical Cumulative Performance January 1990 - June 2009



Source: 2009 Atlantic Trust and Zephyr StyleAdvisor

Hedge funds provide strong risk-adjusted returns to a balanced portfolio of traditional equity and fixed income investments, preserve capital and decrease portfolio volatility due to their low correlation. They, too, are making adjustments in the way forward – changing fund terms to match their underlying investment strategy. Investors are more closely evaluating hedge funds and segmenting them into more distinct categories of market-directional liquid, "classic" hedge fund liquid and illiquid strategies. In addition, in a post-Bernard Madoff world, hedge funds will reflect investors' – and regulators' – demands for more transparency and operational rigor.

Investments in hedge funds by institutions saw dramatic growth from 2003 to 2007, with non-profits increasing their investments from $38 billion in 2003 to $125 billion in 2007. Corporate pensions' investments also grew, from $15 billion to $60 billion; by the end of 2008, pension funds' investments in hedge funds grew from 15% of total investments to 25%. Further significant growth is expected – projections are for pensions to make a cumulative net inflow to hedge funds of $252 billion by 2013. Also by 2013 it's projected that 10% of all hedge fund assets will be held by high-net-worth private investors.[5] Corporate defined benefit plans may be the group most actively seeking opportunistic returns from alternative investments – at the close of 2008, 92% of plans in S&P 500 companies were underfunded. Given the S&P 500's most recent 10-year record of -2.22% return, it's clear that these defined benefit plans will need to allocate to alternatives more broadly.[6] Returns from their almost 85% allocation to equities and fixed income will fall far short of making up their current funding gap.

It's All About the Manager

Liquidity is a fundamental focus of the asset allocation framework of Atlantic Trust. The firm's balanced asset allocation portfolio recommends 30% allocated to cash and liquid bonds and the Capital Preservation portfolio recommends 48%. To achieve both growth and preservation, all portfolios call for investments in alternatives – 23% in the most conservative, the Capital Preservation portfolio. The proof for the strategy is in the numbers, Lisanke points out. "As you move along the investment spectrum from large-cap stocks to real estate and hedge funds, correlation numbers provide the case for diversification." The most important element in the success of alternative investments is one word: manager. In the public long-only markets, the difference between a good manager and a poor manager is typically about 2 to 3% annually over a market cycle. But with an alternative investment such as venture capital, for example, the difference can be 20% a year. Selectivity of alternative investment managers through an intense due diligence process is a hallmark of Atlantic Trust's Multi Manager Investment Committee.

"Risk is ever-present in investing," says Lisanke. "The way to manage risk is to invest in a variety of asset classes with different risk and return profiles. The endowment model may have hit a rough patch for some universities recently, but it's clear that a carefully developed allocation that includes alternatives is not just for Harvard anymore." ■

1 New York Times, *September 11, 2009 http://is.gd/3gFDn*
2 *"Leaving Harvard Greener,"* Business Week, *January 24, 2005, <http://is.gd/3gG6j>*
3 *Bloomberg.com*
4 *TIAA-CREF 2008 NACUBO Endowment Study*
5 *The Bank of New York Mellon and Casey Quirk Analysis 2009*
6 *S&P 500 10 year annualized return through June 2009; Zephyr StyleADVISOR*

Taxing Issues: Policy and Possibilities for 2009 — and Beyond

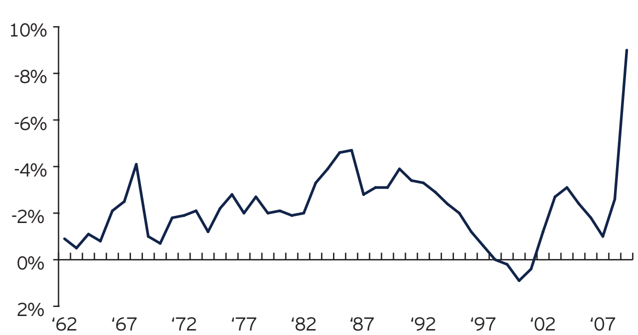
Q&A with Daniel Clifton

According to most economic indicators, we're moving out of recession and into recovery. But that doesn't mean the picture of "the way forward" is clear. Indeed, one of the biggest questions about our economy and its fiscal health is: How will we pay for everything proposed?

The government's updated budget figures show a $1.5 trillion budget deficit for 2009. This deficit period will probably last longer than first expected because it's structural in nature – it has very little to do with the financial crisis and the stimulus plan, of which only $93.6 billion has been spent so far.[1] Why is this important? Because the task of the Treasury to finance a $1.5 trillion deficit this year, and probably next year, will be difficult, especially with many key decisions on raising revenue through taxes expected this year and in 2010. Tax revenue as a percent of GDP is below 16% for the first time in history – with six million people out of work and not paying taxes. Government spending as a percent of GDP is at its highest level ever, other than two years during World War II, and will probably hit 26% of GDP. This unsustainable gap between tax revenues and spending will result, as always, in debate about whether increasing taxes for those with higher incomes will blunt our economic recovery, but it's worth pointing out that tax rates on the highest earners were three percentage points higher during the 1990s – during a very strong economic cycle.[2]

Cyclically Adjusted Budget Deficit, Percent of GDP

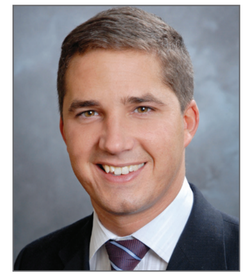
1962 - 2009



Source: Congressional Budget Office; Office of Management and Budget.

Congress must take action this year on several key tax issues – the estate tax, tax cuts enacted during the Bush administration and income tax rates. The average effective income tax rate for all taxpayers was 12% in 2007, at the peak of an economic cycle, so it's probably inevitable that taxes will rise. But how much – and will there be new taxes? Will "fixes" be permanent or temporary? How can we use what we know, or at least what we predict, to help you make smart decisions about estate planning, gifting and investing?

For answers on these questions, we talked with Daniel Clifton, partner and head of policy research at Strategas Research Partners, a leading investment strategy, macroeconomic and policy research firm. Clifton's expertise is in research and analysis on the intersection between legislation, policy and capital markets. We're privileged to share Clifton's "insider" perspective with you.



Daniel Clifton
Strategas Research Partners

Q What is the likely fate of the estate and gift tax – will we see repeal, extension or a return to previous levels?

A We're likely to see a temporary "fix" for the estate tax, freezing it at 2009 levels – a 45% rate after the $3.5 million exemption – to ensure that it doesn't go to zero in 2010. Senator Max Baucus, D-Montana, chairman of the Senate Finance Committee, wants the estate tax resolved permanently in 2010 and is on record as wanting to repeal the estate tax, although he also acknowledges he doesn't have the votes. The estate tax is an issue important to his constituents, many of whom are farmers and ranchers. Although it might be tempting in a year with a big budget deficit, there's a very low probability that any fix in late 2009 will be retroactive to the beginning of the year.

Compounding the need to address current law that would allow the estate tax to expire in 2010, with the attendant lack of revenue that would entail, is that tax cuts enacted during the Bush administration expire at the end of 2010. While most of the rhetoric gets focused on tax cuts at higher income levels, those cuts ended the marriage penalty, doubled the child credit and created a 10% tax bracket. It's difficult to imagine Democrats letting those middle-class provisions expire going into an election year. Still, there are shortfalls to make up.

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Taxing Issues: Policy and Possibilities for 2009 — and Beyond

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Q What changes are expected for tax rates on long-term capital gains and qualified dividends?

A The 15% rate on qualified dividends and long-term capital gains was extended through 2010 in the Tax Reconciliation Act of May 2006. Changes to these taxes will probably be a 2011 story. There's been talk of the capital gains rate going to 20%, but it's more likely to be 25%. Rep. Charles Rangel, D-N.Y., chairman of the House Ways and Means Committee, is against retroactive tax increases, so even if it goes to 25% in 2011, there's ample time in 2010 to respond with planning strategies. It's also important to point out that while capital gains rates may not rise per se, there is talk of putting a 5% surtax on adjusted gross income (AGI), which includes capital gains and dividend income. It's a back-door way of raising the capital gains rate. We're watching that closely.

Q What can we expect in the areas of ordinary income taxes and new types of taxes?

A The income tax rate will probably be significantly higher in the next five years, with one of the main proposals being the surtax on AGI. The alternative minimum tax (AMT) will probably rise along with income tax rates, as it always does. Without that, more taxpayers fall under ordinary income tax rates, which generate less revenue than the AMT. President Obama has proposed putting caps on certain deductions, and we probably will see deductions flatten.

Other possibilities for tax changes include an increase in the income limit on which Social Security taxes are paid – or a "doughnut" hole after $102,000 in income with the Social Security tax reappearing at $250,000 – another look at the tax advantages of annuities and new corporate taxes, including one on international income. In addition, former Fed Chairman Paul Volcker, who heads the president's Economic Recovery Advisory Board, will deliver a long-awaited report on tax reform in December. We believe it will include a value-added tax (VAT) or some other tax on consumption. Although that would probably be difficult to pass into law, the administration is going to rely on both Volcker's credibility and the message that we can't sustain the current budget deficit. An increase in Social Security taxes or a VAT-type tax are the types of increases that can result in $200 billion a year. There's a lot of money that needs to be "found," and it's clear that our politicians are going to consider every option, including asking those at the top end of the economic spectrum to pay more. ■

Atlantic Trust has prepared a white paper with more details on taxes, tax policy and tax planning strategies. If you would like a copy, please speak with your advisor.

1 *www.recovery.gov <http://www.recovery.gov>, "Reporting the Progress," as of September 4, 2009*
2 Wall Street Journal, *September 3, 2009*

Two to Watch

Sen. Max Baucus, D-Montana, has been in the news more recently for his version of a health care reform bill, but he's also a key player in any legislation on taxes, in particular the estate tax. As chairman of the Senate Finance Committee, he's on record as wanting the estate tax fully repealed "because of the threat that it poses to Montana's ranchers, farmers and small businesses." **Paul Volcker,** former Federal Reserve Chairman, was tapped by President Obama in March to head a complete review of the tax code aimed at closing loopholes, streamlining the law and generating revenue. His review is to conclude by December 4, leaving time for proposed changes to be included in the White House budget for fiscal 2011. ■

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