

Quarterly Investment Perspective

Push and Pull

A Letter From Marc D. Stern, Chief Investment Officer

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Dear Client,

It was an eventful quarter.

And that's not just because of the stories that led words like vuvuzela, dispersant, and Eyjafjallajökull to enter the popular lexicon.

A mosaic of troubling developments damaged investor confidence, including fiscal trauma in Europe, China's programs to rein in its housing market, and weak U.S. job growth.

Gyrating Markets

This backdrop led to remarkable volatility across a range of markets. At one point during the quarter, investors demanded a 12.4% yield to own Greek government bonds; at another point, just 6.5%. All of Europe came under the microscope, prompting the euro to trade as high as \$1.37 and as low as \$1.19 — a huge range for just 90 days. But the gyrations weren't confined to a single region or market. Oil traded as high as \$87 per barrel and as low as \$67, while the S&P 500 fluctuated between 1217 and 1030.

All told, global stocks were down 13% in the quarter. A few smaller markets gained ground, including Chile, Indonesia, Peru, and the Philippines. But most of the larger markets were down substantially, including the U.S. (-12%), U.K. (-15%), Germany (-15%), Russia (-17%), Brazil (-14%), Australia (-20%), France (-21%), and China (-23%).

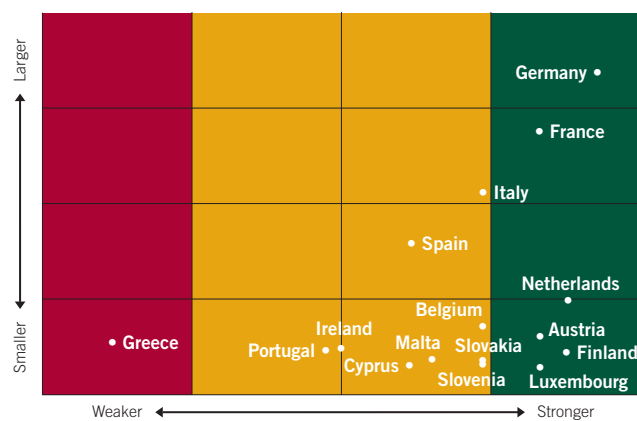
Turbulence will likely be with us for a while. Investors abhor uncertainty, and without immediate catalysts for the resolution of current issues, it looks like the primary cure will be time. Indeed, our views on the global economy reflect a mixed picture.

Fiscal Problems in Europe

Europe isn't a case of "one size fits all."

As shown in Exhibit 1, we assess Greece's dire fiscal situation as unique among euro-zone members. A restructuring of its debt obligations will likely occur at some point, which already appears to be baked in to market prices. But among Europe's smaller countries, the Netherlands, Austria, Finland, Luxembourg, and Belgium appear sound, with Portugal, Ireland, Cyprus, Malta, Slovakia, and Slovenia in moderate condition. Most of the larger countries, especially Germany, are stronger.

Exhibit 1: Euro-Zone Economic Landscape



As of June 30, 2010.
Stronger/weaker assessment is based on government debt levels, bond yields, credit default swap prices, and economic policies, breadth, and depth.
Source: Bloomberg, International Monetary Fund, OECD

Of course, conditions in Europe will change as developments unfold. The most critical battleground for policymakers seeking to restore investor confidence is likely Spain, where leaders are dealing with the aftermath of a huge construction bubble and 20% unemployment. There are no easy solutions. But there are some offsetting strengths: the country's substantial size and economic diversification, recent enactment of some needed reforms, and success lately in attracting bidders to government bond auctions.

The complexity of Europe's challenges creates the need for region-wide cooperation. The banking system is highly intertwined, with French and German banks owning substantial quantities of debt issued by Greece, Portugal, and Spain. Moreover, many European banks have high financial leverage and insufficient transparency.

Complicating matters is the euro zone's structure. A monetary union without political union is not an ideal foundation for decision-making in times of crisis. It was a notable accomplishment, therefore, for European Union leaders to agree in May on a far-reaching, credible rescue plan. However, infighting curtailed the momentum and highlighted policymaker ambivalence about the pace and magnitude of implementation. Resolving the fiscal challenges is a question of political will, so it is impossible to be sure how things will play out.

History tells us that until policymakers feel pressure to make needed changes, little happens. Europe's worsening backdrop has sparked extreme market volatility, which has gotten the attention of policymakers. They have begun to take steps that wouldn't have been feasible a few months ago, prompting protests by many union members. Also helping to bring about change is the recent drop in the previously high-priced euro, which has improved the global competitiveness of the region's companies.

A key milestone for Europe will be dissemination of bank "stress tests." If investors sense that results are "sugar coated" by relying on unreasonably gentle loss assumptions, the tests will likely do more harm than good. We believe investors are braced for bad news from the banks and won't be shocked by the truth. So if these tests are done properly, banks could have an opportunity to raise needed capital and refortify their balance sheets.

Many investors are likening the current situation to the credit crisis of 2008. But we believe recent developments are an *echo* of the prior crisis, not a *replay* of it. The differences versus two years ago are notable.

- Policymakers were slow to recognize problems in 2008 but are now on full alert.
- Longer-term bonds yielded little more than short-term paper two years ago, which compressed bank earnings. Now we have one of the steepest yield curves on record, enabling banks to book significant profits.
- LIBOR, which is the rate at which banks can borrow from one another, has risen from its lows but is well below its crisis levels of two years ago.
- In 2008, large corporations had serious trouble accessing overnight financing; now they are rolling over their commercial paper with ease.

China's Rapid Growth

Keeping perspective on Europe's problems requires recognition of growth potential in important economies elsewhere. China's economic growth has been nothing short of remarkable, rising from \$300 billion to nearly \$5¹/₂ trillion over the last quarter-century. The question now is whether the government will be successful in fine-tuning economic activity, including cooling its real estate market without crushing growth. We address this issue and more in the Roundtable beginning on page 8.

U.S. Jobs, Small Businesses, and Consumers

In the first six months of the year, the U.S. economy created 590,000 private-sector jobs, and the unemployment rate declined by a half-point. While these are substantial improvements from the depths of 18 months ago, the job market remains unusually weak.

Problems are especially evident in the construction sector, where headcount has declined by 28% since peaking nearly four years ago. Job losses have hit less-educated workers especially hard: Americans who didn't complete high school have an unemployment rate of 15%, versus a 4¹/₂% rate for college graduates.

Beyond its enormous environmental implications, the BP oil spill is leading to job losses in energy, fishing, and tourism on the Gulf Coast. Moreover, the euro zone's difficulties are hampering the job outlook, since about 19% of U.S. exports head to the region. In addition, state and local governments have reacted to budget shortfalls with 10 consecutive months of job cuts.

Nonetheless, several positive factors are evident to us:

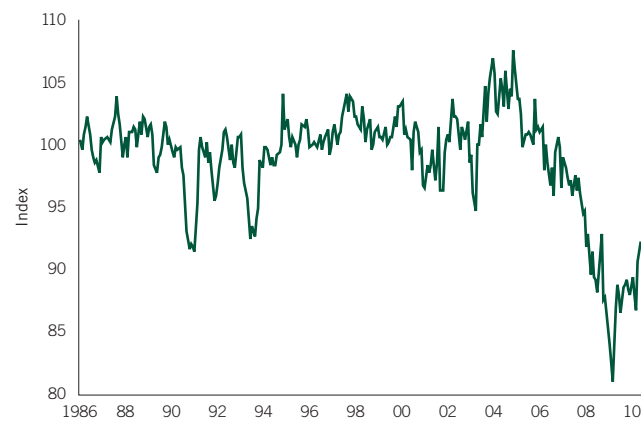
- World trade has bounced back from its lows last year. As new orders pick up, many companies have begun to rebuild their headcount to keep pace.
- An improving tone is apparent in the latest corporate survey data. For example, after 28 consecutive months of employment weakness, a key report issued by the Institute for Supply Management has revealed two months of stable results.
- As economic recoveries develop, companies tend to focus initially on increasing their use of temporary workers and extending the workweeks of their existing employees. We have now seen an increase in temporary workers for nine straight months, and the average workweek has increased gradually since last fall.

A robust job recovery is highly unlikely, especially with small business owners remaining under pressure. Sentiment among business owners reached record lows in mid-2009 as new orders plunged and bank credit dried up. At this stage, the availability of credit remains a serious concern because bankers have tightened their lending standards. As a result, even longstanding customers with solid relationships at their local banks are being told that credit will be limited or not available at all. This situation is unlikely to change much in the near term, which will hamper the ability of small business to drive substantial employment growth.

Nevertheless, we believe the worst may be over for this sector. Government data on "proprietors' income" — a helpful measure of independent company profitability — has stabilized lately after

falling in 2008 and 2009. The pace of new orders has rebounded from prior lows, prompting a slight recovery in small business sentiment (Exhibit 2).

Exhibit 2: Small Business Sentiment



As of May 31, 2010.

Source: National Federation of Independent Business

Consumer thrift in response to the financial crisis and ensuing job uncertainty has contributed to declines in debt over the last 18 months. The adjustment has been rapid, and we expect another two to three years of reductions in household debt obligations relative to income. A weak job market combined with continued debt reduction suggests retail sales will remain sluggish in the quarters ahead.

The Federal Reserve understands the fragile nature of the economic recovery and has kept monetary policy stimulative. Low interest rates have helped borrowers maintain low payments on adjustable-rate obligations, including mortgages with repricing mechanisms. Interestingly, a framework developed by Stanford professor John Taylor, which has a good track record in anticipating the Fed's interest rate policy, indicates that the ideal current Fed Funds rate is -2%. A negative rate is highly unlikely, of course, but this analysis reinforces our view that the Fed will be in no hurry to raise rates amid today's tame inflation.

Slowing economic activity in many geographies has intensified fears of a "double-dip" recession. While we cannot rule it out, we expect to avoid it

(Exhibit 3). China, India, and Brazil are growing faster than expected, the U.S. is still on track for 3% growth, and Japan has picked up somewhat. All of this is enough to offset deterioration in the euro zone and the U.K. A lot can change in six months' time, but as of midyear, our 2010 forecast of 3½% global growth appears on track — and may even be slightly low.

Exhibit 3: Global Economic Growth

GDP Growth

	2007	2008	2009	2010E	
				As of Dec 2009	As of Jul 2010
China	13.0%	9.0%	8.7%	9.0% →	10.0%
India	9.4	7.3	7.2	6.0 →	8.0
Brazil	5.7	5.1	(0.5)	4.0 →	5.5
U.S.	2.1	0.4	(2.4)	3.0 →	3.0
U.K.	2.6	0.7	(5.0)	1.5 →	1.0
Euro Zone	2.7	0.7	(4.1)	1.5 →	0.5
Japan	2.3	(0.7)	(5.0)	1.5 →	2.5
Global	5.2%	3.0%	(1.0)%	3.5%	3.8%

As of July 2010.

Source: Capital Economics, International Monetary Fund

Investment Opportunities

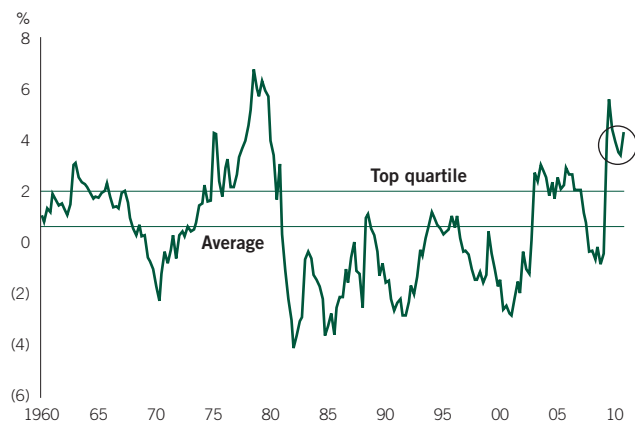
Over the last year, investors have moved enormous sums into bond funds. Stock funds have received little support. Yet, in our minds, with yields much lower than usual, one of the most compelling anomalies today appears to be the potential for stock returns to outpace bonds.

In Exhibit 4, we compare the stock earnings yield versus the government bond yield over the last 50 years. A stock earnings yield is essentially a price-to-earnings ratio turned upside down: a P/E of 13 equates to an earnings yield of about 7½%, more than 4 points higher than the yield on government bonds.

When the line is below normal, we can conclude that bonds appear unusually attractive in relation to stocks. But when the line is high — as it is today — the benefit goes to stocks over bonds. This

Exhibit 4: Stocks vs. Bonds

Stock Earnings Yield vs. Government Bond Yield



As of June 10, 2010.

Stock earnings yield and government bond yield based on S&P 500 Index and 10-Year Treasury Bonds. Quartile rankings based on stock earnings yield minus bond yield since 1960. Reflects median total returns over subsequent 12 months.

Source: Global Financial Data, Standard & Poor's

Stock vs. Bond Returns Are Linked to Starting Point

Quartiles Since 1960	Probability	Average Return Differential
	Next year's U.S. stock return > Treasury bond return	Next year's U.S. stock return minus Treasury bond return
1st	81%	11.3%
2nd	64	3.8
3rd	56	1.8
4th	22	(7.1)

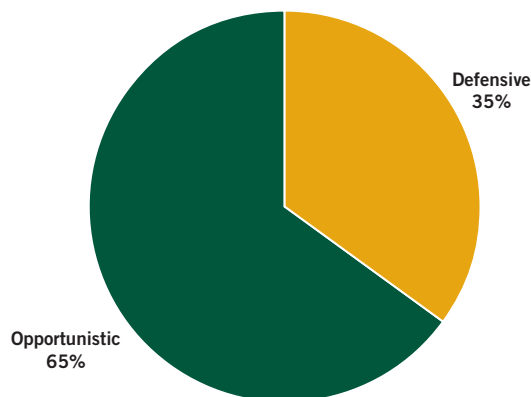
reading does not guarantee any particular outcome, but history shows that when it's unusually high, stocks go on to outpace bonds in 81% of the 12-month periods that follow. The return differential in these periods is generally substantial, averaging more than 11%.

In this environment, our research teams are uncovering many global companies with strong competitive positions, whose stocks trade at attractive valuations. Areas of current emphasis include industrials (e.g., Honeywell – aerospace and controls, Ingersoll-Rand – diversified commercial products, Metso – Finnish machinery maker); materials (e.g., Dow Chemical – specialty chemicals and advanced materials, Crown Holdings – metal packaging); and consumer (e.g., Omnicom – advertising agency, Accor – hotels).

Equities represent one component of our overall positioning in opportunistic investments. As shown in Exhibit 5, our Balanced Growth allocation is 65% invested in opportunistic areas. In addition to stocks, we own high-yield, convertible, emerging-market, and mortgage-backed bonds that offer substantially better return potential than government bonds while having less downside

risk than equities. We also see some opportunities in commodities, as well as in emerging-market currencies, especially in Asia. And we have exposure to a range of carefully selected equity-oriented hedge fund managers.

Exhibit 5: Combining Offense and Defense
Balanced Growth Asset Allocation



As of June 30, 2010.

Bessemer's recommendations may be adjusted due to a variety of factors, including changes in market conditions, economic growth, corporate profitability, geopolitical conditions, and inflation. Investments cannot be made directly in these model portfolios. Because each client has different spending needs, liquidity requirements, time horizon, risk tolerance, and tax circumstances, individual implementation will vary.

Alternative investments, including Bessemer hedge funds of funds, are not suitable for all clients and are available only to qualified investors. Exposure to other alternative investments, including private equity and real estate, may also be appropriate for qualified investors.

At the same time, we recognize there will be market setbacks. With 35% of our Balanced Growth allocation dedicated to defensive areas, we believe we are well positioned for the choppy markets we envision. These investments include high-quality fixed income, TIPS, precious metals, and absolute-return-oriented hedge funds.

In total, we believe this structure will help us participate in stronger market periods while limiting losses in tougher times.

Performance Summary

In a six-month period when global stock prices declined 9.0% and commodities dropped 9.6%, our flagship Balanced Growth portfolio fell 4.1% (Exhibit 6).

Losses are always disappointing, and we are not satisfied with year-to-date results. Particularly frustrating to us was performance in the U.S. Large Cap portfolio, which trailed its benchmark by 5% due largely to weakness in defensive areas including Baxter, Celgene, Teva, and Walgreen. Trading at 11 times the normalized earnings power we foresee, the portfolio appears to offer substantial upside potential over time. The Real

Return portfolio also fell short of expectations, as economic recovery moderated and inflation remained mild. Over time, we believe inflation protection will be an increasingly important component of client portfolios.

At the same time, our returns were helped by strength in the Global Opportunities portfolio. Substantial exposure to corporate credit has proved defensive in a volatile market, and currency positioning was helped by weakness in the euro. In addition, the Non-U.S. Large Cap portfolio fell by less than its benchmark. Performance was particularly strong in the European consumer sector.

Our central focus remains on building sensible overall portfolios that will achieve our clients' long-term investment objectives. Over the last five years, for example, our overall Balanced Growth allocation delivered higher returns than relevant indexes, with the added benefit of lower volatility along the way.

Maintaining a high-caliber team of professionals is key to our efforts. During the second quarter, we were pleased to welcome David W. Rossmiller to the firm as head of fixed income. David brings

Exhibit 6: Performance Overview

	Year-to-Date Returns	Annualized Returns			Annualized Volatility	
		1 Year	3 Years	5 Years	3 Years	5 Years
Bessemer Balanced Growth Portfolio	(4.1)%	9.2%	(2.9)%	3.6%	12.3%	10.2%
U.S. Stock/Bond Mix	(3.0)	13.3	(4.5)	1.3	15.0	12.1
Global Stock/Bond Mix	(2.8)	12.1	(3.6)	2.8	14.5	11.8
S&P 500 Index	(6.7)	14.4	(9.8)	(0.8)	20.7	16.8

As of June 30, 2010. Past performance is no guarantee of future results.

Volatility is measured by annualized standard deviation of monthly returns. This figure is most meaningful over multiyear periods.

The Balanced Growth Portfolio represents a model portfolio comprised of U.S. Large Cap, Non-U.S. Large Cap, Global Opportunities, Global Small & Mid Cap, Real Return, Fixed Income, Strategic Cash, and three Bessemer hedge funds of funds.

Bessemer returns are before fees, except for those asset classes invested in mutual funds or alternative asset funds, which are after fees. Please see page 7 for a complete description of Bessemer's Balanced Growth Portfolio and benchmarks.

25 years of investment experience, most recently as Global Head of Fixed Income for Deutsche Bank Private Wealth Management. In overseeing strategy, implementation, and communication, David is working closely with Hal S. Woolley and Bruce A. Whiteford, who played central roles in his hiring and will continue as portfolio managers.

In uncertain times, choppy markets will likely persist. Yet we are convinced that recent market volatility has opened up interesting opportunities across much of the investment spectrum, and I look forward to updating you on our strategies and results in coming quarters.

Sincerely,



Marc D. Stern
Chief Investment Officer

Past performance is no guarantee of future results.

The Balanced Growth Portfolio represents a model portfolio comprised of U.S. Large Cap, Non-U.S. Large Cap, Global Opportunities, Global Small & Mid Cap, Real Return, Fixed Income, Strategic Cash, and three Bessemer hedge funds of funds. Investments cannot be made directly in this model portfolio. Relative weightings in this model portfolio vary over time. Returns for Old Westbury Global Opportunities Fund, Old Westbury Global Small & Mid Cap Fund, Old Westbury Real Return Fund, and Bessemer hedge funds of funds are after all fees and expenses. All other returns reflect performance of Bessemer Common Trust Funds and are before fees and expenses. The results also include the reinvestment of all dividends and capital gains.

Global Small & Mid Cap Fund returns began April 5, 2005. Real Return Fund returns began April 28, 2005. Global Opportunities Fund returns began November 28, 2007. Bessemer hedge funds of funds returns for this model portfolio began July 1, 2005, are preliminary and are subject to revision.

Alternative investments, including Bessemer hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

Prior to July 28, 2008, the Non-U.S. Large Cap Fund was named the International Fund and operated under a different investment strategy. Prior to October 2, 2008, the Global Small & Mid Cap Fund was named the Global Small Cap Fund and operated under a different investment strategy and the U.S. Large Cap Fund was named the Large Cap Equity Fund. The prior performance shown represents performance of these funds' prior strategies.

The Global Stock/Bond Mix reflects a mix of the S&P 500 Index (25%), S&P Mid Cap 400 Index (10%), MSCI EAFE Index (14%), MSCI World Small Index (5%), MSCI Emerging Markets Index (3%), HedgeFund.net (10%), Dow Jones-UBS Commodity Index (2.5%), Barclays Government/Credit Bond Index (25%), Barclays U.S. TIPS Index (2.5%), and Treasury Bills (3%).

The U.S. Stock/Bond Mix (70/30) is a composite of 70% S&P 500 Index and 30% Barclays Government/Credit Bond Index.

Source: Barclays Capital, Dow Jones, Federal Reserve, Morgan Stanley Capital International, Standard & Poor's, UBS

The Investment Roundtable: The Chinese Question

J. Alex Christie, Real Return Analyst

Gregory M. Lester, Global Opportunities Portfolio Manager

Marc D. Stern, Chief Investment Officer

China boasts a \$5 trillion economy, the fastest growing among major countries and one soon to become the second largest in the world. As such, its outlook plays a central role in the vitality of the global economy. Three senior investment professionals discuss China's changing dynamics in everything from real estate to consumer trends — and the investment opportunities that appear most attractive now.

Q: China's stock market has sold off sharply this year, and investors appear worried about a slowdown. What's behind this?

Stern: The concern is centered on China's property market. Throngs of buyers have pushed home prices up by more than 50% in Beijing over the last year. Other large markets including Guangzhou, Shanghai, and Shenzhen have also surged. On the heels of this housing boom, policymakers have grown increasingly concerned about a potentially traumatic bursting of the bubble and have implemented new measures to cool down the market. Investors fear that China could overcompensate in its efforts to pull back, harming its economy and the world's.

Christie: On a recent trip I took to China to evaluate potential commodity investments, construction was everywhere. Skylines in places like Shanghai and Beijing were littered with skyscrapers and cranes, and newly constructed high-rise apartments and commercial buildings were ubiquitous. Moreover, the subject of real estate dominated conversations. Everyone — citizens, government officials, businessmen — wanted to talk about whether growth could continue, where the deals were, or what would happen next.

Speculation is an enormous part of the market. One of my Chinese guides, a recent graduate from a Wyoming business school, couldn't afford a house in Guangzhou where he worked, so he opted to rent one there and buy a house in a less developed city far away as a speculative investment. Because many others in China purchase properties for similar reasons, a large percentage of homes go unoccupied as owners wait for prices to appreciate. That's one of the key reasons for the government's recent crackdown.

Q: Why is everyone focused on real estate as opposed to other investments?

Christie: Because the Chinese don't have many attractive options for putting their ample savings to work. The government limits its citizens' overseas investments, and even within its borders, the Chinese have limited flexibility. Interest rates for savings accounts are below the rate of inflation, meaning that deposits lose purchasing power. Chinese stocks are notoriously volatile and are virtually unchanged versus a decade ago. Property, though, is seen as a real asset that serves as a hedge against inflation, which many citizens remember as a menace from the 1990s. Moreover, owning a home of one's own is widely regarded as a significant personal milestone.

Q: What steps has the government taken to cool the property market?

Stern: In April, officials announced a tough package of restrictions on property lending and purchases. First, the central government mandated that banks raise the minimum down payment for those purchasing a second home from 40% to 50%. Then, it barred banks from issuing mortgages to nonresidents who hadn't paid local taxes or fees and allowed local governments to limit the number

of properties an investor can buy within a specific period. In the statement announcing this measure, policymakers warned that speculation and surging property prices pose a real threat to China’s financial stability and economic development.

Q: Are the government’s measures working?

Stern: Yes. Residential property transactions in major Chinese cities have fallen sharply since the new measures were announced. Home sales in Beijing and Shanghai, for example, plunged almost 70% in the first month. Chinese local media also reported that China’s largest listed developer, Vanke, is poised to cut housing prices in Beijing and Shanghai by 10% to 30% in the next several months as a result of the government’s policies.

We have gained important perspective on the slowdown through a consultant who performs on-the-ground market research for us in China. She recently visited a series of housing developments to gauge sentiment from buyers and sellers. During one of her visits, she spoke to a real estate agent who claimed that in Shenzhen, 3,000 housing contracts were broken in May because banks refused to issue a mortgage to potential buyers who had already made a deposit. In fact, she found that at one residential development in Shenzhen, apartment prices fell from 21,000 yuan to 11,000 in a single day.

Over time, additional policy changes are likely, including the initiation of property taxes to provide a steady revenue stream to local governments. This change would reduce their need to facilitate new property developments to create tax revenue from developers. In addition, it would raise property owners’ carrying costs, which would likely reduce speculative buying.

Q: With falling real estate prices, will the Chinese economy plunge like those of other countries we’ve seen in the last few years?

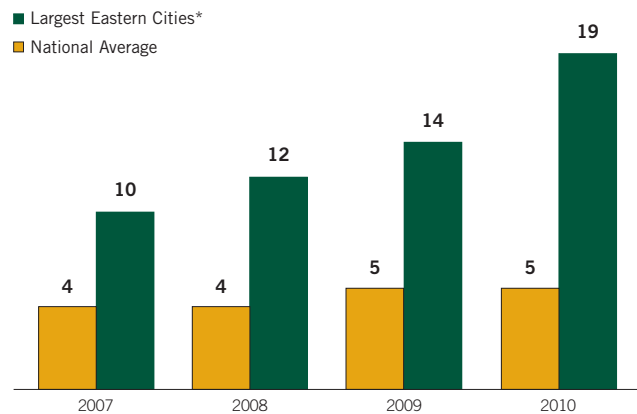
Stern: No, we’re convinced otherwise. Policymakers in China are trying to slow the market, not destroy it.

Their actions over the years have demonstrated a great deal of flexibility, and we expect them to relax their tightening later this year — in time to avoid causing a crash.

Christie: In addition, the Chinese post substantial down payments when purchasing a home. There are no subprime loans, “no-doc” loans, or home equity lines. In relation to income levels, household debt in China is about one-third that in the U.S. So even if home prices were to fall considerably, we believe the systemic risk for the Chinese economy would be much less than it was for the U.S., U.K., Ireland, and Spain in the recent bursting of their housing bubbles.

Stern: Also helping to prevent a housing collapse is the fact that 80% of homes lie outside the most overheated cities. As shown in Exhibit 7, the average price per square meter has grown moderately on a national scale, even though prices in the prosperous eastern cities have risen substantially. Moreover, the demand for homes throughout China will likely continue to grow over time as the country’s prosperity increases.

Exhibit 7: China’s Home Prices
(thousands of yuan per square meter)



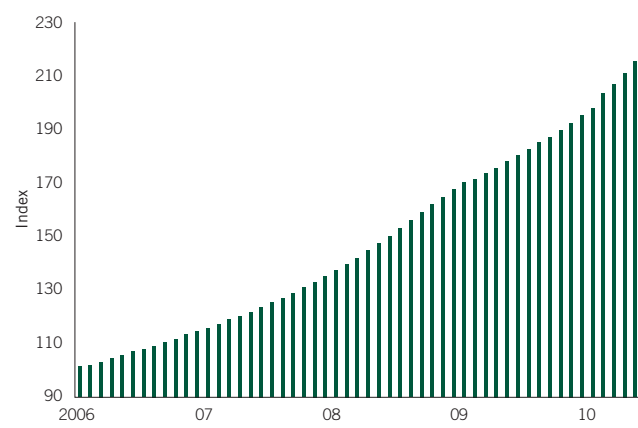
As of May 31, 2010.
*Average of Beijing, Guangzhou, Shanghai, and Shenzhen.
Source: CEIC, CLSA

Ultimately, we think the government will be successful in reining in speculative purchases and runaway prices — while limiting the slowdown in overall economic growth.

Q: But if property markets are losing steam, where will future Chinese growth come from?

Stern: From the Chinese consumer. Certainly, trade with other countries will continue to be a key driver, but we're beginning to see a fundamental shift in the economy toward higher domestic consumption. Substantial job creation and high savings rates have boosted household wealth and confidence, prompting many citizens to spend more. Moreover, increased consumption has become more culturally acceptable, particularly among younger generations. All of these factors are sparking substantial growth in retail sales (Exhibit 8).

Exhibit 8: China's Retail Sales



As of May 31, 2010.
Source: National Bureau of Statistics of China, FactSet

Q: Can you give some examples of what Chinese consumers are buying?

Christie: Certainly. Here are some recent statistics on consumption:

- Auto sales in China increased nearly 50% last year to 13.6 million, marking the first year more cars were sold in China than the U.S.
- Air conditioning sales were up 30% in 2009.
- Food patterns have shifted, too. Around the world, as individuals emerge from poverty, one of their first priorities is increasing their consumption of proteins. China is no exception, with chicken consumption up fourfold over the last 25 years. A heartier, protein-rich diet is replacing the less expensive staples they've eaten in the past, such as rice, wheat, and corn.

- Demand for branded items is growing. In one shopping center in Beijing, I saw not only standard worldwide chains such as McDonald's and Starbucks, but also upscale stores such as LensCrafters, Harley-Davidson, and Burberry. On the streets, designer boots and brand-name clothing were as apparent as they are in New York City. Volkswagen is China's leading auto brand, and KFC has 2,950 restaurants in 650 cities around the country.

Q: Are government officials taking steps to support the rise of Chinese consumption?

Stern: For the most part, yes. When the Chinese government passed the nearly \$600 billion stimulus package back in November 2008, one of the primary goals of the policy was to spark greater consumer spending through increased lending from state-owned banks and a more accommodating healthcare and retirement safety net.

More recently, many policymaker actions have reflected stronger support for workers seeking higher wages and improved benefits. For instance, several provinces have raised minimum wages, and the government has allowed some noteworthy labor strikes — such as those recently directed at Honda. Large companies including Daimler AG, Compal Electronics, and Hon Hai Precision Industry have implemented worker-friendly measures amid increasing pressure from workers and the Chinese government.

Wage increases this year help make up for stagnant growth in 2009. Prior to the global economic crisis, nominal wages in China had been rising on average about 14% per year for the last two decades. The latest gains, therefore, are a resumption of a long-term trend rather than a sudden spark for rapid inflation.

Lester: It's important to note, too, that part of this upward pressure on wages stems from an increasing labor *shortage* in the country, driven by a combination of high economic growth (and demand for

workers) and fewer young people entering the workforce (because of the nation's longstanding one-child policy). There's also reluctance on the part of some citizens to take on more menial jobs in a period of greater prosperity.

Q: Won't higher wages hurt China's status as the world's chief exporter of low-cost goods?

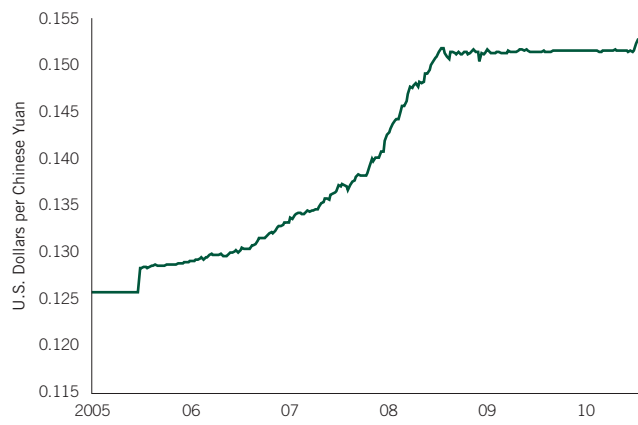
Stern: Yes, and that's probably just fine with the leadership in Beijing. The government realizes it can't employ one billion people in low-cost manufacturing plants, especially since Vietnam, India, and other countries are increasingly able to compete as low-cost producers. Instead, China is eager to move up the value chain by producing higher-value goods, especially through support for domestic "champion" companies — those with innovative methods and international acclaim — in industries ranging from appliances and automobiles to alternative energy and computer software.

While higher wages stand to benefit the Chinese consumer, policymakers could still do more to spur domestic consumption by continuing to allow the yuan to appreciate.

Q: Can you explain what's going on with China's currency and how it might help the consumer?

Lester: In June, China announced it would begin to make its exchange rate more flexible, paving the way for the yuan's future appreciation. This was significant because, while most currency values oscillate from day to day according to market forces, China had pegged the yuan to the U.S. dollar for nearly two years in an effort to promote stability (Exhibit 9). We believe that, in doing so, policymakers depressed the currency's value well below what market levels would imply, given China's strong trade surplus, low government debt levels, and position as the fastest growing major country in the world.

Exhibit 9: Chinese Yuan



As of June 30, 2010.
Source: Interbank rate, FactSet

To help keep the yuan from rising against the dollar, China has amassed roughly \$900 billion of U.S. Treasuries, a sizeable portion of its \$2.45 trillion foreign-exchange reserves. However, the recent policy change will not likely sway China away from holding dollar-denominated bonds, especially at a time when the largest bond markets in Europe and Asia are not particularly attractive.

Stern: China's underpriced currency has helped its manufacturing base by making its exports relatively cheap, but it has hurt Chinese consumers by diminishing their purchasing power. Now that China has signaled it will reinstate its policy of allowing the yuan to fluctuate somewhat, we expect it to appreciate over time. This should foster greater internal demand and bring the yuan closer in line with what the market would demand.

Q: Will a higher currency hurt Chinese industry?

Lester: Not right away. Policymakers are actively controlling this transition to ensure that China's exports remain competitive in global markets. The policy shift will likely be measured enough that investors won't see significant changes in corporate earnings anytime soon.

Over time, though, certain Chinese industries will experience margin pressure because of a strong yuan, particularly producers of low-cost, low-technology products. But other industries will actually profit from this change. The biggest beneficiaries will likely be Chinese importers whose costs are mainly in dollars and revenues are mainly in yuan. Examples include Chinese airlines, computer manufacturers, and steel and coal importers.

Stern: It's worth remembering that this latest move is not something new for China, which has undertaken a balancing act over the last five years between making industry competitive and empowering consumers. From 2005 to 2008, the yuan was allowed to appreciate by 20% before policymakers suspended the policy at the onset of the global financial crisis.

The most significant consequences of a higher currency value will likely be a somewhat lower risk of a global trade war and continued improvements in Chinese citizens' standard of living.

Q: Overall, then, do you expect the Chinese economy to sustain rapid growth?

Stern: Yes. The next leg of growth will stem from investments that extend the country's prosperity from the eastern cities to the central and western provinces. Widespread development of high-speed rail lines, roads, and airports are reshaping urban infrastructure. Among other large infrastructure projects, we expect China to add another 10,000 miles of railways over the next two years, much of which will drive growth in central and western regions of the country. Already we are seeing some global companies choose new plant locations far from the big eastern cities that used to dominate their focus.

Christie: One of the most striking things about my recent trip was the remarkable contrast between the eastern and western parts of the country. Cities like Beijing, Shanghai, and Guangzhou looked like

major cities in any other developed nation, with towering buildings, strong infrastructure, modern roads, international cars, clean streets, upscale stores, and new technology. However, moving west, the landscape changes very quickly, and the difference is stark. In more rural areas, it's commonplace to see dilapidated buildings, sprawling towns, dirt roads, rusted signs, and outdated factories with inefficient technology and poor working conditions. In fact, one place I visited was a copper smelting plant in Yunnan, which used a Soviet-era furnace to smelt copper. In some regions, water was visibly polluted and air quality was so poor that my eyes burned.

Statistics bear out this discrepancy: Last year, per-capita income for those living in China's largest cities, which are primarily in the east, was more than twice that of those living in rural areas, according to the Organization for Economic Cooperation and Development. This is one of the reasons why some of the greatest growth opportunities for the nation lie in the rural, underdeveloped west.

Q: Did you get a sense for Chinese citizens' attitudes toward the economy while you were there?

Christie: We felt a strong sense of optimism. Between conversations with Chinese workers, investors, and students, we perceived underlying feelings of opportunity and possibility — a mentality that those who work hard, have ideas, and are willing to persist can be successful in the emerging Chinese economy. This deep-seated excitement about economic prospects and development was suppressed by political and economic developments in China during much of the twentieth century, but it didn't disappear.

Of course, concerns linger. As we said earlier, the housing market continues to play on citizens' minds, as the government attempts to keep prices in check without stifling growth. There's also concern over the wide gap between rich and poor, which could not only limit future growth but also exacerbate

social tensions. Finally, there are fears about the downsides of China's torrid growth: pollution, overinvestment in speculative projects, and the risk of the same hyperinflation that overtook the economy in the not-too-distant past.

Q: Is inflation in fact a realistic concern for China right now?

Lester: It's always a concern, but we don't expect it to skyrocket anytime soon. The Chinese government has done an admirable job of controlling inflation to date — mostly through nontraditional measures. Instead of raising official interest rates, policymakers have increased reserve requirements at Chinese banks, enacted tougher restrictions on housing speculation, and signaled a willingness to allow the yuan to appreciate. As a result, banks have less money available to lend, the housing market's ascent has tempered, and — assuming China follows through on its plan to allow the yuan to appreciate — consumers will require fewer yuan to buy the same amount of goods. For these reasons, we believe that Beijing has taken the appropriate measures thus far. That's not to say that inflation couldn't become a serious issue in the future; as China's economy continues to march ahead and wages continue to rise, policymakers will have to remain vigilant to ensure growth comes at a sustainable pace.

Q: Given Bessemer's expectation that China's construction boom will slow and consumer spending will grow, how are you positioned from an investment perspective?

Christie: In the Real Return Fund, the latest research has led the team to undertake the following actions:

Lower construction-related commodities weightings. These include raw building materials, such as copper.

Raise consumer-related commodities weightings. Because increased consumption has fueled greater demand for cars, the Fund owns positions in three metals that should benefit from China's

nearly 50% growth in auto production: platinum, palladium, and lead. Platinum and palladium are both used heavily in emissions-control devices for cars and trucks, and 80% of all lead produced goes toward car batteries. The Fund has also initiated a position in cotton, whose price should benefit from a combination of tight supply and increased demand for clothing in places like China. The Fund's investment in the diamond mining company Harry Winston is based on the team's expectation that continued wealth creation in developed and emerging economies should raise the demand for luxury items such as fine jewelry. Finally, Real Return has a stake in logs and lumber company Sino-Forest based on the thesis that increased Chinese consumption will coincide with heightened demand for household furniture, paper, and tissues.

Q: What about other Chinese companies?

Stern: We remain wary of building substantial direct investments in China. There are notable risks associated with investing in Chinese equities, arising from limited management teams, transparency, and trading liquidity, along with a poorly enforced legal and regulatory infrastructure. Reports of fraud and corruption — with little recourse for recouping losses — rightfully give investors reason for pause.

Because of these risks, we prefer to emphasize more transparent companies with exposure to the Chinese market. For example, in the Non-U.S. Large Cap portfolio, we own shares of luxury German automaker Daimler AG, whose revenues from China increased 60% annually for the last five years. Another example is LVMH, the French-based company that sells Louis Vuitton fashion goods and Hennessy Cognac. The rapid increase in the number of wealthy Chinese consumers should be an advantage for LVMH, whose high-end brands have continued to gain traction throughout emerging Asian markets.

Christie: The Real Return Fund currently invests in just two other Chinese companies. One is Xinao Gas Holdings Limited, a natural gas distributor benefiting from higher usage in residential areas, and the other is a real estate company in which the Fund is currently building a position. In each case, the team's research suggests the return potential of these investments outweighs the hazards.

Stern: Given the risks of investing in China, it's important to have people on the ground who can speak the language and investigate firsthand — to interview a company's investors, former employees, industry leaders, and competitors to get a sense for its operations and any conflicts of interest between management and shareholders. The same consultant who helped us survey the residential real-estate environment has played a helpful role for us in assessing individual companies.

Lester: In fact, her market research regarding a Chinese medical company confirmed our suspicions regarding the company's deteriorating prospects, prompting us to exit our position in its convertible bond. We're finding better opportunities now in convertibles in other regions throughout the world, especially Europe, where the sovereign debt crisis has prompted an indiscriminate sell-off of corporate bonds. Since fundamentals for European companies vary widely, it presents the opportunity to invest in companies that have been unfairly lumped with weaker firms despite having strong balance sheets.

Q: Does that mean the Global Opportunities Fund has no exposure to China?

Lester: On the contrary, about 7% of the Fund is allocated to the Chinese yuan through forward contracts. Also, the team is investing in nearby Asian countries that are benefiting from China's growth such as South Korea, Malaysia, and Taiwan, through equities, currencies, and government bonds.

Q: You mentioned Korea. What do the escalating geopolitical tensions on the peninsula mean for China?

Lester: China is the key moderator here and one of the most important factors in keeping the two countries from war. It's in the best interest of China to prevent any military action between the Koreas since regional instability would threaten its own political and economic systems. Considering the size of its economy — and the control it has over key North Korean resources (in the past, China has cut off the supply of oil to North Korea) — China has the ability to play the role of peacekeeper here.

It's also important to remember that, though the dialogue between North and South Korea has grown more heated recently, this tension is not new. Overall, the current discord between both nations seems unlikely to have a substantial impact on the Chinese economy.

Q: Is all the attention on China justified?

Stern: Yes — and no. China tends to evoke strong emotions. Some people see it as a compelling growth story and investment opportunity; others see it as a dangerous power with substantial risk of economic collapse. Both camps have come to fixate on China's every move. We're convinced such extreme views do not reflect reality.

We think China's growth will likely remain strong for years to come, especially as expansion in the central and western provinces brings hundreds of millions more Chinese into the global economy. The national leadership's proven success and flexibility in overseeing dramatic economic advances is impressive and should not be underestimated. Moreover, the inherent optimism of the Chinese to make life better for their children is inspiring.

Yet most companies in China don't offer the transparency, breadth and depth of management, and focus on shareholder rights that we would like to

see. The country's treatment of global companies and its own citizens hasn't reached the standards of leading economic powers. Cycles of boom and bust in the property sector will continue to be a risk. China's population is aging. And pollution remains a huge and intractable problem.

In our minds, therefore, China cannot be described in simple or uniform terms. Longer term, the country's future will be determined by the pace and methods by which it opens up economically and politically. In the meantime, though, China's strong growth prospects will continue to shape most global industries, meriting close attention by our investment research teams.

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