

# A Letter to Clients

## Maintaining Perspective

### A Letter From Marc D. Stern, Chief Investment Officer

Dear Client,

The extraordinary market movements over the last several weeks — global equity indexes have fallen 16% since July 22 — have left many investors unnerved. At difficult times such as these, it is essential to assess both the market outlook and our portfolio strategies.

At the core of the sharp downturn is an absence of confidence. Rising debt levels in Europe and the U.S., uncertainty about policymakers' willingness to restore fiscal order, and increasingly cautious corporate sentiment that is consistent with slowing global growth are the chief culprits. For more details, please see our recent market updates, "A Question of Confidence" (August 4) and "U.S. Downgrade" (August 7).

For some time, we have retained significant defensive measures. These include holding elevated cash, maintaining substantial exposure to less-volatile corporate credit, and diversifying away from currencies and bonds of countries with higher debt. Moreover, additional cash has been raised within portfolios recently to further limit downside risk. Equity market exposure in our Balanced Growth portfolio is below normal at 40%, with the remaining assets spread across cash (10%), fixed income (30%, including government and corporate credit), hedge funds (12%), and commodities and currencies (8%).

Although our current positioning would cause our performance to trail the equity indexes if a rally were to develop — a plausible outcome with overall liquidity at very high levels and most corporate balance sheets in strong condition — we believe there is too much uncertainty today to warrant a more aggressive approach. Part of our central mission is to preserve our clients' wealth, which means limiting losses during market setbacks. Our Balanced Growth portfolio has lost 40% less than the global equity markets in the recent downturn. Nonetheless, broad diversification hasn't provided as much protection as we have seen historically because of indiscriminate selling pressure across most asset classes. In addition, our low exposure to government bonds hasn't worked in our favor because a flight to quality has pushed Treasury yields implausibly lower. We anticipate these strategies will become more effective once market movements become less extreme.

Amid the selloffs, we are not adding to growth-oriented assets as we normally would, even though equity and commodity prices will likely move meaningfully higher over time from current levels, with returns well above those of cash and bonds. The recent unusual movements for currencies, government bonds, and financial stocks all indicate serious stresses. The Swiss franc has become extremely overpriced and continues to move higher; U.S. government bond yields, despite the recent downgrade, continue to move lower, with five-year Treasury bonds now yielding just 1.1%; and some large financial stocks, an area we are underweight, have lost nearly 40% of their value in the last month. Such moves can create feedback loops, where declines feed on themselves as they trigger reactions such as margin calls for leveraged investors and increased capital requirements for banks.

As welcome as Tuesday's gains were, we expect markets will likely remain highly volatile in the near term. Even though fears about a global recession appear overdone, an extended market decline could indeed derail the recovery. Ultimately, confidence will need to be restored before we see much progress. This will take time, and it hinges on the ability of policymakers around the world to lead. We will be looking for evidence of increased commitment from the U.S. government to restore long-term fiscal health, and greater actions by euro zone leaders to achieve unified fiscal policy. We will also look for business sentiment to improve enough that it can support a sustainable recovery in employment levels. If these developments do not happen, we could see further downgrades for the U.S., deterioration of the euro zone, and higher unemployment. But if they do occur, the future could be considerably brighter than widely believed.

We are closely monitoring economic and financial developments, and we continue to carefully manage your portfolios through this tumultuous period. We will keep you informed of our strategies as conditions evolve.

Sincerely,



Marc D. Stern  
Chief Investment Officer

Return estimates are through August 8, 2011.

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