

Quarterly Investment Perspective

Weighing Risks

A Letter From Marc D. Stern, Chief Investment Officer

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Controlling Volatility**

Dear Client,

The global economy moved toward a broad slowdown in the third quarter.

Of course, for many families it feels like the 2008-2009 recession never ended. In the 27 months since economists officially declared it over, an average of only 4.3% of Americans responding to Conference Board surveys have described jobs as “plentiful.” But there have been some notable bright spots during this period. Led by the manufacturing sector, U.S. exports rose 37%, corporate profits surged 53%, and private-sector payrolls added more than 1 million jobs.

Now, though, readings from many leading indicators are consistent with the onset of recession. Inventory levels are rising faster than new orders, corporate sentiment is worsening, and consumer sentiment remains mired at very low levels. Notably, too, the yield investors demand to purchase corporate debt is sharply higher.

None of this means global growth will disappear. In fact, worldwide GDP still appears on track to increase by more than 3% this year and next, giving well-positioned companies ample room to sustain strong profits. Accordingly, our investment approach takes into account both the current difficult macroeconomic environment and the wide-ranging investment opportunities we see emerging.

A Different Downturn

If a recession is indeed developing, it is doing so in an unusual way. Normally, economic downturns follow a well-worn path: a period of good growth leads to excess — too much hiring, too many new homes, too much optimism; then, tighter policies choke off burgeoning inflation, ushering in a healthy cleansing that helps the economy prepare for its next advance. This time, though, a different dynamic is at work. Despite accommodative policies and abundant liquidity,

there appears to be a collective decision to wait: companies are waiting before they hire more people or build new plants; consumers are waiting before they buy a new home or car; and investors are waiting before they commit cash to buy stocks or corporate bonds.

At the heart of this collective pause is a pronounced deterioration of confidence, reflecting widespread skepticism that leaders have the judgment and will to implement sound policies in Europe and the U.S. Events over the summer were particularly disconcerting, with European leaders failing to take decisive action even as Greece's debt crisis worsened and U.S. leaders raising the debt ceiling only after an acrimonious debate featuring both sides publicly warning of an economic meltdown if their policies weren't adopted.

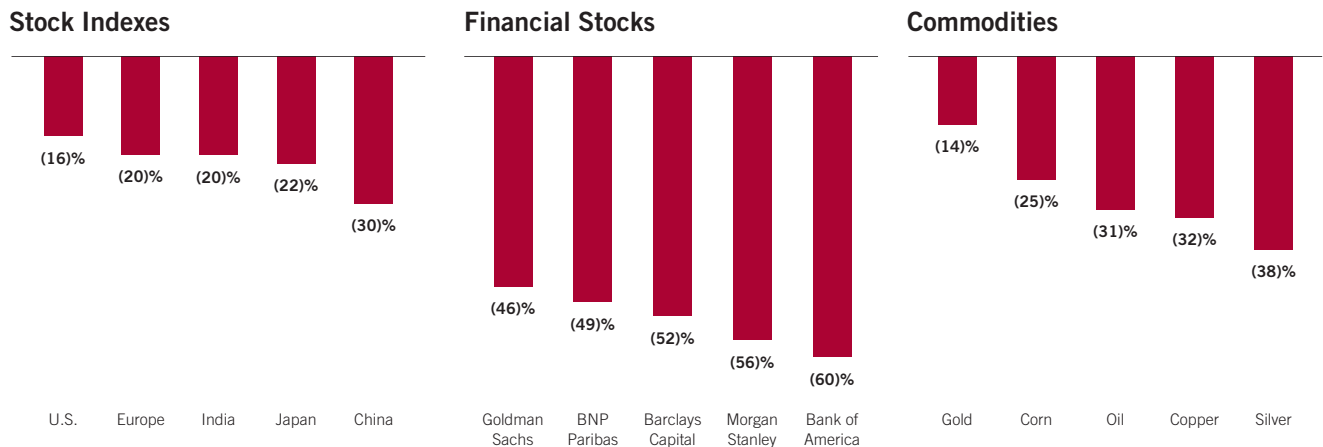
Rising uncertainty has led investors to fear the worst, sparking sharp price adjustments. As shown in Exhibit 1, significant corrections have unfolded in a wide range of equities and commodities around the world.

Recent volatility has felt eerily reminiscent of the period leading up to the 2008 financial collapse, when similar declines were followed by even sharper losses. But even as we foresee some additional pressure in the months ahead, we do not anticipate a repeat of the trauma of three years ago.

Indeed, we see many factors likely to help companies and consumers withstand an economic downturn. Corporate profits have been strong, and companies haven't over-hired the last few years, so there is less need to cut back than in prior recessions. Most firms have used robust cash flow to strengthen their balance sheets, and major banks in the U.S. have significantly reduced their leverage. Among consumers, a combination of higher savings, lower interest rates, and increased foreclosures has pushed household debt obligations as a percent of income to their lowest levels in a decade (Exhibit 2). By this time next year, debt service could drop to levels we last saw in the early Eighties. Moreover, the outlook for consumers is brightened by meaningful drops in prices for many food and energy commodities. No wonder many major retailers have been reporting stable or slightly improved same-store sales, leading to forecasts of a 2-3% rise in the upcoming holiday season.

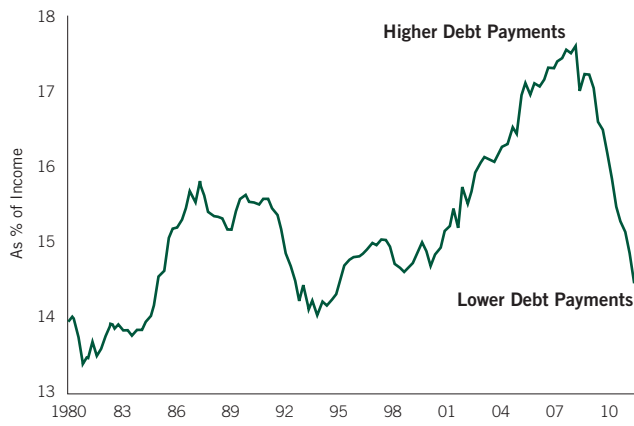
Exhibit 1: Sharp Price Adjustments

Percent Change from 2011 Peak



As of September 30, 2011.
Source: Bloomberg, FactSet, Morgan Stanley Capital International, Standard & Poor's

Exhibit 2: Reduced Consumer Debt Obligations Household Debt Service



As of June 30, 2011.

Household debt service ratio (DSR) is an estimate of the ratio of debt payments to disposable personal income for U.S. consumers. Debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.

Source: Federal Reserve

What would happen to stock prices if a recession were to develop? Normally, recessions induce a 30% drop in corporate profits. If price-to-earnings ratios were high during the good times, a combination of falling earnings and falling valuation multiples can cause stock prices to be cut in half — as seen in 1973-1974, 2000-2002, and 2008-2009.

But if price-to-earnings multiples are already low and companies are already lean (both of which appear to us to be the case now), then the market damage can be contained. If a recession caused earnings to drop 20% and price-to-earnings multiples were to settle at 12 to 13 times (a meaningful discount to the market's historical norm of about 15), we would expect the S&P 500 Index, which stood at 1131 on September 30, to settle near 1050 — a much better outcome than the low of 670 reached in 2009.

Government Debt Problems

The outlook could be meaningfully better or worse depending largely on the actions of policymakers in Europe and the U.S. It is impossible to know exactly how the issues can be resolved in a way to brighten investors' moods. But we know that policymakers in both geographies face mounting pressure for bolder

action to restore fiscal health. It is rapidly becoming riskier for politicians to do nothing than to address problems head-on.

The problems in Europe appear especially difficult to resolve because doing so requires agreement from many constituencies. Bureaucratic headwinds were especially apparent in July. An agreement to increase funding for distressed governments within the euro zone initially led markets to rally, but optimism faded when it became clear that each of the 17 member countries would take their time to evaluate and vote on the proposals. Approval requires unanimous consent. It is an unusual system that gives Slovakia, with GDP representing about 2% that of Germany and France, the ability to veto a package favored by Chancellor Angela Merkel and President Nicolas Sarkozy. By quarter's end, several euro zone countries still hadn't approved the funding initiative announced with fanfare in July.

But as frustrating as the process in Europe has been for investors over the last 18 months, we can't lose sight of the commitment that key European leaders have to preserving the euro. Taken alone, the largest country in Europe (Germany) is little more than half the size of China or Japan and less than one-fourth the size of the U.S. But collectively, Europe is as big as all of Asia taken together or the U.S. A coordinated Europe is seen as destiny. As Chancellor Merkel said earlier this month on the efforts to keep the euro zone intact, "We are determined to do whatever is necessary."

Ultimately, we foresee a three-step program from Europe:

- First, restructuring Greece's debt and providing European banks with additional capital. Resolving the Greek crisis will require applying "haircuts" to the value of its debt. Seeing this likelihood, investors have grown reluctant to provide the overnight funding needed by banks that own a lot of the distressed paper. To absorb these bond markdowns and regain market confidence, European financial institutions (especially in France

and Germany) will need a substantial infusion of equity — likely from a combination of public and private sources.

- Second, implementation of what is known as the European Stability Mechanism. This program will provide substantial funding with broad powers to “safeguard the stability of the euro area.” Although it is scheduled to be launched in 2013, we expect policymakers to begin calming investors with increased funding in coming months.
- Even as the first two actions could stem the crisis and move markets onto firmer ground, a sustainable longer-term solution will likely require a third step: a comprehensive plan to establish a European Treasury with the power to collect tax revenue and issue euro bonds. Giving up some autonomy will be a particularly painful move for individual countries, so we expect this final step to proceed more slowly over the next few years.

Of course, debt is also a concern in the U.S. Congress and the president have received two wakeup calls recently: first, the insightful report issued last December by the deficit commission headed by Erskine Bowles and Alan Simpson, followed by Standard & Poor’s decision in August to downgrade long-term U.S. government debt.

The debt-ceiling legislation passed by Congress over the summer created the Joint Select Committee on Deficit Reduction. The 12-member group, chaired by Democratic Senator Patty Murray and Republican Congressman Jeb Hensarling, is charged with identifying \$1.5 trillion in deficit cuts by November 23. Frankly, it is difficult for us to see how this group will reach a consensus given the deep philosophical divide between members such as Democrat John Kerry and Republican Pat Toomey. Moreover, four of the committee’s members also served on the Simpson-Bowles commission last year — and all four voted against the sensible plan that was put forth then. Perhaps, though, the repercussions of inaction can compel a compromise. If the new committee can’t agree on a package of savings, or if

Congress doesn’t approve the committee’s package by December 23, automatic across-the-board cuts totaling \$1.2 trillion will be triggered. At some point, the U.S. will make needed changes to its spending and its tax code. Whether this committee will pursue this path seriously remains to be seen.

At this time of broad uncertainty, we find it particularly helpful to assess a range of possible outcomes. Exhibit 3 lays out four scenarios. Moving from right to left:

Lehman Brothers Part II. A disorderly default in Greece quickly spirals into a deep crisis in which some large banks become insolvent and global capital markets freeze up. Corporate earnings plunge, leading to a sharp drop in equity prices.

Deep Recession. Policymaker missteps — such as European banks receiving too little capital, the European Central Bank remaining overly focused on fighting inflation, or Congress deferring needed fiscal changes — further erode corporate, consumer, and investor confidence. Paralysis sets in, causing a painful contraction of economic growth. Both profits and stock prices suffer, but do not collapse.

Shallow Recession. Governments take some action, but fail to diminish the broad uncertainty. Most corporations have the wherewithal to weather a mild recession, so earnings fall modestly while equity prices retreat somewhat from current levels.

Modest Growth. Emboldened policymakers act more decisively and make visible progress on long-term solutions. Confidence gradually returns, economic activity slowly picks up, and profits rise. The positive developments lift equity markets.

We don’t expect the most negative scenario to develop because European leaders appear to understand the severity of complete collapse. As President Sarkozy said earlier this month, “The failure of Greece would be the failure of all of Europe. Remember in 2008, when the U.S. let Lehman Brothers fail, the global financial system

Exhibit 3: Range of Outcomes

| | Modest Growth | Shallow Recession | Deep Recession | Lehman Brothers Part II |
|--------------------------|---|---|---------------------------------------|--|
| Impact of Policy Actions | Advances toward solutions gradually lift confidence | Progress comes too late to avoid slow-down, but corporate strengths persist | Missteps intensify lack of confidence | Disorderly European defaults rattle financial system |
| Corporate Profits | \$105 | \$85 | \$75 | \$55 |
| Earnings Multiple | 13x | 12x | 12x | 12x |
| S&P 500 | 1350 | 1025 | 900 | 650 |
| Estimated Probability | 40% | 45% | 10% | 5% |

As of September 30, 2011.

paid the price. For both economic reasons and moral reasons, we can't let Greece fail."

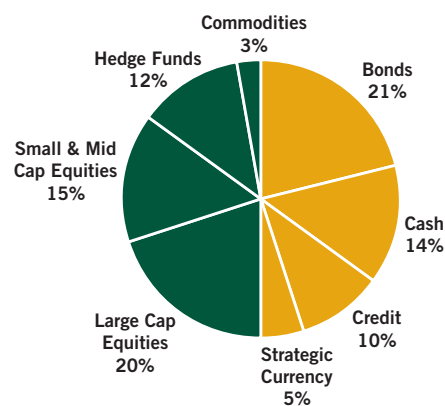
Most recessions are mild, and we believe the factors discussed earlier will prevent a deep contraction from developing. A shallow recession or modest growth is more likely — with the ultimate determinant being policy decisions.

Portfolio Positioning and Performance

Our investment approach emphasizes balance, in that we seek to participate meaningfully in rising markets while limiting losses in falling ones.

In today's difficult environment, we have incorporated significant defensive measures into our investment strategy. For some time, we have held elevated cash levels, which we have raised further recently as economic risks have built. For example, as of early October, our two large cap portfolios are each holding more than 45% cash, and approximately 50% of the Real Return Fund is in defensive holdings. As shown in Exhibit 4, in our Balanced Growth model portfolio, cash, bonds, currencies, and credit investments stand at a higher-than-normal 50%.

At the same time, we retain exposure to growth-oriented assets. These include 38% of Balanced Growth invested in equity and commodity markets, as well as 12% in hedge funds. These categories will likely benefit over time if worst-case economic scenarios miss the mark as we expect.

Exhibit 4: Balanced Growth Portfolio Weightings

Reflects Balanced Growth allocation as of September 30, 2011.

The sharp declines in market prices during the third quarter led our Balanced Growth model portfolio to fall 8.7% for the nine-month period (Exhibit 5). Losses are never satisfying. Moreover, our performance did not live up to our historical standards. The following factors contributed to our results:

Detractors

- Reducing the weighting of bonds and shortening the duration of our bond portfolios hurt our results. As we entered 2011, five-year Treasury bonds yielded a mere 2%, which we felt represented poor investment value. However, the flight to safety in the third quarter pushed these yields implausibly lower to less than 1%.

- Our philosophy of investing globally detracted from our returns in this nine-month period, as the S&P 500 Index did meaningfully better than markets elsewhere (falling about 8.8 percentage points less than developed non-U.S. markets and 12.9 points less than emerging markets¹).
- Our large cap equity portfolios were positioned for continued recovery with exposure to industrials, materials, and energy stocks, which have underperformed as fears of an economic slowdown have grown.

Positives

- Favorable security selection in Global Small & Mid Cap, Real Return, and Global Opportunities positioned these funds to outperform their benchmarks.
- Significant credit exposure provided some protection from the downside of equities.
- Elevated cash levels throughout the third quarter helped to offset some of the downturn.

In some ways, our strategies are not changing. For example, we are maintaining our bond positioning because we remain convinced that high-quality bonds are richly priced, with limited return potential and above-normal risks over the next few years. In addition, we remain committed to investing globally — seeking to uncover the most compelling investment opportunities regardless of geography. Staying true to these views puts us in the best position to meet clients' long-term investment objectives.

In other ways, though, we stand ready to make significant changes. An example is our cash level, which is higher than normal due to unusual risks as policymakers seek to restore confidence and avoid recession. We are poised to deploy this capital once we see evidence of lasting progress in Europe and the U.S. Moreover, we believe the changes to our large cap portfolios slated for late November will improve the consistency of our performance (see next section).

Ultimately, we aim to have most of our portfolios outperform most of the time. Doing so has helped us achieve a long-term track record of delivering superior returns with controlled volatility.

Redefining Our Large Cap Portfolios

Our commitment to excellence requires an open mind to change. Over the last several years, we have enhanced our investment platform to increase its global nature and flexibility to access a wide variety of asset classes and investment strategies.

As we communicated to you in September, in our next stage of evolution we are refining our two large cap portfolios. We believe the changes will maximize the consistent delivery of superior investment performance.

Exhibit 5: Performance Overview

| | Year-to-Date 2011 | Annualized Returns Ended Sept. 30, 2011 | | | Volatility | |
|---|-------------------|--|-------------|-------------|--------------|--------------|
| | | 1 Year | 3 Years | 5 Years | 3 Years | 5 Years |
| Bessemer Balanced Growth Portfolio | (8.7)% | (2.1)% | 2.9% | 2.0% | 13.0% | 11.5% |
| Global Balanced Growth Index | (6.6) | (1.0) | 3.5 | 1.8 | 14.7 | 12.7 |
| U.S. Stock/Bond Mix (70/30) | (3.9) | 2.6 | 3.8 | 1.4 | 15.1 | 13.0 |
| S&P 500 Index | (8.7) | 1.1 | 1.2 | (1.2) | 21.3 | 18.3 |

As of September 30, 2011. **Past performance is no guarantee of future results.**

See page 7 for a complete description of Bessemer's Balanced Growth portfolio and benchmarks.

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

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

¹ Reflects local returns as of September 30, 2011.

Three key factors drive our thinking:

- **Globalization.** Large firms like BMW, Chevron, General Electric, Michelin, and Samsung are best analyzed as global competitors rather than by the address of their home office.
- **Volatility.** Market turmoil has intensified investors' focus on limiting portfolio volatility, and innovative analytics can enhance the consistency of returns.
- **Resources.** Experienced investment talent within Bessemer can be complemented by carefully selected external managers. We have seen success in managing global portfolios in this way in Global Small & Mid Cap and Global Opportunities.

Instead of being defined by geography (U.S. versus non-U.S.), our two large cap equity portfolios will be structured around distinct volatility objectives beginning in late November. Both of the new portfolios, Large Cap Core and Large Cap Strategies, will seek to deliver superior returns, but the Core portfolio will also emphasize controlling volatility while the Strategies portfolio will emphasize distinct complementary investment strategies.

Large Cap Core will be available in separately managed accounts and will be managed by an internal team headed by me and two associate portfolio managers.

Large Cap Strategies will be available only as a mutual fund and will be overseen by a Bessemer team led by Portfolio Manager Lois Roman and two associate portfolio managers. Two external

managers will complement the Bessemer team's approach. Oldfield Partners is a deep value manager based in London that emphasizes global equities trading at significantly discounted valuations. Sands Capital Management is an aggressive earnings growth manager based in Virginia that emphasizes global companies with superior prospects for rapid growth.

The two portfolios are paired within our overall approach to large cap equities. Taken together, the objectives will be strong absolute returns, outperformance of the benchmark, and controlled volatility.

As we discuss in the Investment Roundtable on page 8, limiting portfolio fluctuations is a key component of investing irreplaceable capital. In difficult markets, we believe it is essential to stay true to our investment disciplines, including relying on independent research and objective judgment to build diversified portfolios. Throughout market history, turbulent times have set up opportunities for stronger long-term results. We believe it will be the same this time. I look forward to updating you on our research conclusions, investment strategies, and performance results in the quarters to come.

Sincerely,



Marc D. Stern
Chief Investment Officer

The **Bessemer 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 Currency, and three Bessemer hedge funds of funds. Investments cannot be made directly in this model portfolio. Relative weightings 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. Returns for hedge funds of funds are preliminary and subject to change.

The **Global Balanced Growth Index** represents a mix of the Barclays Capital U.S. Government/Credit Index (25%), S&P 500 Index (15%), S&P Global Large ex-U.S. Index (10%), S&P Global Small & Mid Cap Index (14%), S&P Global Large & Mid Cap Index (14%), Real Assets (7% consisting of Dow Jones-UBS Commodity Index [5%] and Barclays Capital U.S. TIPS Index [2%]), Hedge Funds (10% consisting of S&P Global Broad Market Index (Hedged) [7%] and Barclays Capital U.S. Government Index [3%]), and 3-Month Treasury bills (5%) after 12/31/2010 and a mix of the S&P 500 Index (25%), S&P Mid Cap400 Index (10%), MSCI EAFE Index (14%), MSCI World Small Cap Index (5%), MSCI Emerging Markets Index (3%), HedgeFund.net Fund of Funds Aggregate Index (10%), Dow Jones-UBS Commodity Index (2.5%), Barclays Capital U.S. Government/Credit Index (25%), Barclays Capital U.S. TIPS Index (2.5%), and 3-Month Treasury bills (3%) before 1/1/2011.

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

Index information is included herein to show the general trend in the securities markets during the periods indicated and is not intended to imply that any referenced portfolio is similar to the indices in either composition or volatility. Index returns are not an exact representation of any particular investment, as you cannot invest directly in an index.

The Investment Roundtable: Controlling Volatility

Edward W. Aw, Head of Quantitative Strategies

Peter J. Langas, Director of Investment Strategies

Gregory M. Lester, Portfolio Manager, Global Opportunities Fund

Daphne L. Richards, Director of Hedge Fund Investments

Marc D. Stern, Chief Investment Officer and Portfolio Manager, Large Cap Core

Markets have been moving up and down with greater ferocity. Five Bessemer investment professionals explain what higher volatility means for investors and how Bessemer has positioned its portfolios to control the level of fluctuations that clients experience.

Q: Are big price swings actually happening more frequently — or does it just feel that way?

Langas: Yes, sharp changes in prices are more common than they used to be. Of the stock market's past 1,000 months dating back to 1928, only *six* were more volatile than August. Stock prices rose or fell 2% or more in a single day 10 times in August and 8 times in September — compared to the long-term average of 1.4 days per month. Intraday price swings have also become more erratic. For instance, on October 4, the S&P 500 fell 2.2% over the first five and a half hours of trading — only to surge more than 4% in the final hour to finish up 2.3%. Wild market movements such as these have caused widespread anxiety and evoked memories of the gut-churning instability during the financial crisis in 2008.

Q: What's behind the volatility?

Stern: Fear of the unknown — particularly all the political and economic uncertainty that we discuss in our quarterly letter (see page 1) — is certainly contributing to more skittishness among investors. Resolution of the issues will take time, suggesting volatility is likely to remain high in the near future.

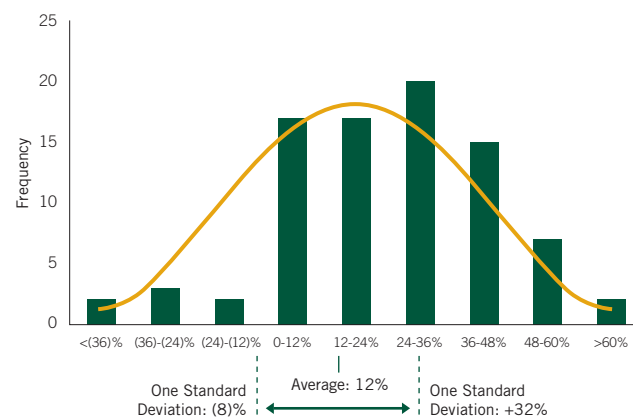
More broadly, though, markets today move faster than ever before because the global economy operates at a swifter pace. Advances in technology allow us to communicate, access information, and trade more quickly and cheaply. In 1973-74, U.S. stocks fell 45% in 21 months and then took 64 months to regain the lost ground. The 2008 financial crisis ushered in another 45% drop — this time in just 7 months, and 22 months later we were back to pre-collapse levels. Same pattern, but three times faster.

Both the turbulence of 2008 and the last bout of volatility have reminded investors that unusually large fluctuations in stock prices can and do happen.

Q: How much volatility is “normal”?

Langas: Since 1926, the S&P 500 Index has delivered an average annual return of roughly 12% and had a volatility of 20%. Volatility is defined by standard deviation, which indicates how far returns deviate from the average (Exhibit 6). The index's 20% volatility figure means that you could expect the index's annual returns to fall somewhere between an 8% loss and a 32% gain approximately two-thirds of the time — or 20 percentage points higher or lower than the average.

Exhibit 6: Distribution of Annual S&P 500 Returns January 1926-September 2011



As of September 30, 2011.
Source: FactSet

However, this means that one-third of the time, returns will fall outside this range. Recent history has exposed the fact that a surprising number of events occur at both extremes. The so-called “fat tails” on the curve — breathtaking price spikes or devastating plunges — are not quite as uncommon as many investors had previously expected.

Q: Should investors be concerned about volatility?

Langas: Yes. Volatility matters because it can erode wealth over time.

Consider the example in Exhibit 7, where two \$10 million portfolios both average an 8% annual return over 10 years but have a very different return pattern. The more volatile second portfolio results in significantly less overall appreciation — about \$2.1 million less than the return for the portfolio with no volatility. That’s what volatility does. It hurts your returns because you have more ground to make up after experiencing losses.

Here’s another way of looking at it: If you have \$10 and lose 50%, you would then have \$5. But if you subsequently gain 50%, you would only have \$7.50 — not \$10. You need a 100% gain to make up for the 50% loss.

If you factor in your spending needs, the drain of volatility becomes even more pronounced because you exacerbate the lost ground when you withdraw assets from your portfolio.

All of this reinforces the point that investors should constantly evaluate not only the potential returns of an investment but the risk they must accept to achieve them.

Q: How does Bessemer evaluate potential return and risk?

Stern: As we assess ways to make money for our clients, we rely on a sophisticated understanding of the characteristics, performance patterns, and current market dynamics of a wide range of asset classes. We base this understanding on the following inputs:

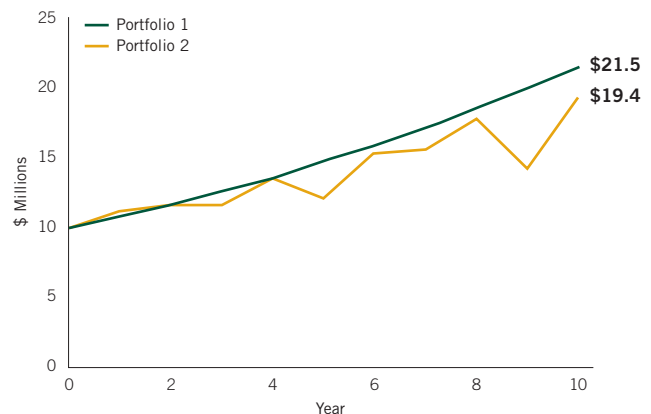
Historical data. We have studied decades of historical financial data, including returns, volatility, and correlations of different asset classes over time and under various market conditions. While history will not repeat itself, knowledge of the past is essential to assessing the future.

Current conditions. Our direct participation in a range of markets gives us access to valuable and timely information that helps us detect areas with unusually high return potential and areas where risks are elevated.

Exhibit 7: Volatility Erodes Long-Term Returns

| Returns | Portfolio 1 | Portfolio 2 |
|------------------------------|-------------|-------------|
| Year 1 | 8% | 12% |
| Year 2 | 8 | 4 |
| Year 3 | 8 | 0 |
| Year 4 | 8 | 16 |
| Year 5 | 8 | (10) |
| Year 6 | 8 | 26 |
| Year 7 | 8 | 2 |
| Year 8 | 8 | 14 |
| Year 9 | 8 | (20) |
| Year 10 | 8 | 36 |
| Average Annual Return | 8% | 8% |

Growth of \$10 million



Langas: Drawing on this knowledge, we look to achieve strong returns at a controlled level of risk in two key ways:

Proactive asset allocation. We select asset classes that complement each other in that they perform differently under similar market conditions. That's why we combine stocks, which have high long-term return potential but can be very volatile, with bonds, which tend to do relatively well when equity markets are doing poorly.

We diversify within asset classes, too. For example, our global mix of equities represents a range of market capitalizations, because large, mid, and small cap stocks have shown different patterns of performance historically. For example, in 1998, large cap stocks outperformed small and mid cap stocks by almost 30 percentage points. But five years later, the roles reversed, with small and mid cap stocks outpacing large cap 45% to 28%.

Commodities, which tend to do well during inflationary periods, provide additional diversification. So do hedge funds, which tend to deliver a performance pattern unlike those of stocks or bonds (although they are not appropriate for all investors).

Based on our research, we have determined an appropriate range for how much to allocate to each asset class, and we proactively shift actual weightings based on current market conditions. Moreover, we can customize each client's portfolio based on his or her return objective and risk tolerance.

Strategy shifts within portfolios. Active portfolio management allows us to take action within individual portfolios to enhance return potential and protect against losses. For example, our equity managers will tilt the portfolio holdings toward defensive stocks — such as utility and consumer staples companies — when the economic outlook dims. At times of extreme market stress, we may also decide to raise portfolio cash levels. Within multi-asset-class portfolios, such as Global Opportunities, the team can shift the allocation

toward more protective strategies. Once our research suggests the outlook has brightened, all of the teams can reposition the portfolios more aggressively.

We firmly believe an actively managed and diversified portfolio is the best way to achieve superior long-term returns at a controlled level of risk.

Q: But hasn't diversification failed in the recent downturns?

Langas: It hasn't lived up to many investors' expectations, but diversification hasn't failed.

In a crisis, fearful investors will flee all riskier asset classes. This was the case in the 2008 financial crisis, which led to losses across portfolios and pronouncements that diversification was dead.

However, diversification *did* work for anyone who owned U.S. Treasury bonds, which rose in value while everything else fell. Diversification does not guarantee positive returns, but holding high-quality bonds can buffer losses in a hostile equity market environment.

With bonds as the core diversifier to stocks, we then diversify among the “risk assets” — like owning non-U.S. stocks or high-yield bonds. Over time, these asset classes don't tend to perform exactly the same way, but that's not to say they perform in opposite ways. Moreover, they may all go down in times of panic — but to different degrees. In 2008, every country took a hit, but Japan dropped 29% compared to a 72% plunge for Ireland. Stocks of utility and consumer staples companies fell significantly less than stocks of materials and energy companies, while high-yield bonds lost considerably less than stocks.

Owning a combination of various asset classes can provide a more favorable risk/return relationship than any one asset class on its own. While the S&P 500 Index fell 37% in 2008, the Global Balanced Growth Index declined 26%.

Even though diversified investors may still suffer losses, they tend to be in better shape once markets recover, having lost less during the fall.

Stern: In the more recent downturn, diversification hasn't provided as much protection as it had historically because of indiscriminate selling across most asset classes — a trend exacerbated by high-frequency trading and highly leveraged ETFs. Nevertheless, our diversified portfolios fell less than the broad equity market in the third quarter, particularly because of our higher-than-usual allocations to defensive strategies, such as cash and credit investments.

Q: Why are credit investments considered defensive?

Lester: Because they typically offer investors more protection than stocks during downturns. While credit investments like high-yield bonds and convertible bonds aren't likely to outperform stocks when equity markets are skyrocketing, they can offer attractive returns while limiting investors' downside. However, not all credit investments are created equal; the likelihood of a company making all of its bond payments ultimately depends on the firm's underlying health. That's why researching a company's balance sheet, cash flow, and management is so important.

One such example is GenCorp, a California-based company that produces equipment for aerospace manufacturers, which has generated strong free cash flow in the last 12 months and has low debt levels relative to cash. The company's convertible bond — a security that pays a coupon while giving bondholders the option to convert the bond into the company's stock — offers strong potential upside with some downside protection. Based on the bond's current

price of \$85 and its 4% coupon, if GenCorp stock were to rise 25% over the next year, the total return on the bond would be approximately 16%. But if the stock were to fall 25% over the same period, the total loss would be only about 3%. This is because the bond has a special provision allowing the holder to sell it back to the company at par (\$100) in 2014.

These types of credit investments are held in the Global Opportunities Fund, which is designed to generate strong absolute returns and outperform a global equity benchmark with low relative volatility.

Q: Are there any other strategies in Global Opportunities that can offer downside protection?

Lester: Yes. The Fund has invested in several equity and equity-related holdings that have compelling risk/return profiles because of temporary market aberrations or dislocations.

Option strategies. Recently, the team began writing covered calls, a strategy of buying a stock while simultaneously selling someone the right to buy it from you at a certain price (a "call option"). Generally speaking, the greater the market's volatility, the more attractive this strategy becomes. That's because investors are willing to pay a higher premium to buy this call from you as uncertainty heightens, which gives you more protection if the stock falls and more participation in gains if it rises (see two hypothetical scenarios in Exhibit 8). The team initiated this strategy in March 2011, when a

Exhibit 8: Covered Calls More Attractive as Volatility Rises

Example: Buy Share of Wal-Mart, Sell Wal-Mart Call Option

| If stock price moves... | The expected total return of the covered call would be... | |
|-------------------------|---|---------------------------------------|
| | Initiated in lower-volatility period | Initiated in higher-volatility period |
| +30% | 7% | 12% |
| 15 | 7 | 12 |
| 0 | 7 | 12 |
| (15) | (5) | 0 |
| (30) | (21) | (16) |

"Lower-volatility period" signifies hypothetical strategy initiated on June 30, 2011, when the implied volatility of Wal-Mart stock was 14%. "Higher-volatility period" signifies hypothetical strategy initiated on September 30, 2011, when the implied volatility of the same stock was 24%. Both covered call examples involve Wal-Mart call options with strike prices modestly below prevailing equity prices at the time. Expected total return is for the subsequent 12 months.

market downturn drove premiums to unusual highs. The Fund added to these positions significantly in the late summer and early fall of 2011 when volatility spiked further.

Another options strategy in Global Opportunities, called risk reversals, lets you participate fully in a stock's gains while positioning you to break even if the stock's price declines to a certain point. Current pricing allows investors to assume less downside risk than normal — *without* foregoing potential gains.

All-equity portfolio targeting low volatility. A small portion of Global Opportunities has recently been invested in a proprietary equity portfolio that looks to achieve superior returns by limiting volatility.

Q: How can you limit the volatility of an all-equity portfolio without compromising returns?

Aw: Through sophisticated analytics and sound judgment. Building on the diversification principles laid out by Nobel Prize winner Harry Markowitz in his 1952 seminal article on portfolio theory, recent academic research has shown that investors can actually enhance their returns in some cases by taking on *less* volatility. They can accomplish this by either 1) creating a portfolio of low-risk securities or by 2) selecting a number of high-conviction securities (independent of their volatility) and then reweighting them in such a way that it reduces volatility. We favor the latter approach because our research has shown that high-conviction securities have a much higher probability of outperforming the market.

Q: How does reweighting the stocks lower the overall portfolio's volatility?

Aw: The weights reflect an “optimal” combination. The risk drivers of the stocks offset each other, at least partially.

Research suggests that certain stock characteristics have historically given us a good indication of how

volatile their returns are likely to be. These include the following:

Sector. Some sectors are more prone to volatility than others. Technology companies, for instance, typically see greater price fluctuations than utility companies.

Size. Larger companies often aren't as susceptible to erratic stock movements as smaller firms, for a variety of reasons: their businesses are generally more diversified and well established, their reach is more global, they have greater access to capital, and their investor base is larger.

Exposure to global interest rates. The trajectory of some businesses is closely tied to movements in global interest rates. If you pair a company that has high sensitivity to rate changes with one that has low sensitivity, that makes the overall portfolio less exposed to these unpredictable movements.

Exposure to currency. Companies whose earnings are strongly influenced by the performance of certain currencies are generally more volatile than firms that have hedged their exposure.

Exposure to oil prices. Because energy prices can oscillate very erratically, companies with businesses that are sensitive to oil price changes tend to have a more volatile earnings pattern than firms with less sensitivity.

Other stock characteristics we consider include region, whether it's in a developed or emerging market, and if it's a value or growth stock. Advances in technology allow us to analyze a company's exposure to all of these factors and consider the correlations between them. These steps should allow us to determine how to weight each of the stocks we wish to hold so as to minimize the overall risk. In simple terms, it amounts to pairing a technology company we like that has a high exposure to currency with a utility company we like with a low exposure to currency. Weighting the two so that their exposures to certain factors are offset can bring the portfolio's volatility lower than it would be otherwise.

Q: Does actual real-life market performance bear this out?

Aw: Yes. In 2001, the makers of the 1,600-stock MSCI World Index launched an index that contained a subset of stocks from the main index, but reweighted them to minimize volatility. From its inception, the MSCI World Minimum Volatility Index has outperformed the MSCI World Index by 3.2 percentage points annually. At Bessemer, we back-tested this approach to see how it would have performed with a portfolio of only high-conviction stocks (those based on our proprietary stock selection model) instead of all the stocks in the MSCI Index. We found that this strategy would have outperformed the MSCI World Minimum Volatility Index meaningfully.

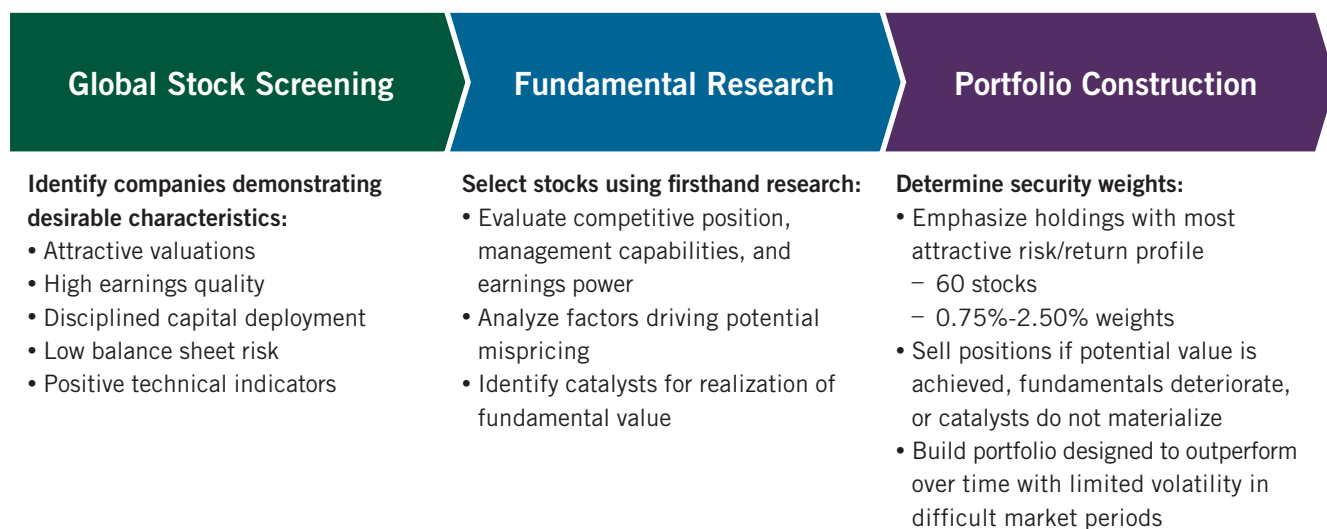
Q: Do we use this approach elsewhere?

Stern: Yes, we will draw on this approach in the new Large Cap Core portfolio. We will launch Large Cap Core in late November when we move away from defining our large cap portfolios based on geography (i.e., U.S. and non-U.S.). We have designed Large Cap Core with a specific objective in mind: The portfolio will seek to deliver superior returns over full market cycles *with less volatility* than the broad equity market.

The investment process will include both fundamental research and quantitative analytics (Exhibit 9). We have nearly 1,000 potential securities to choose from, and we will identify those companies demonstrating a set of characteristics we believe are desirable. For example, we want attractive valuations in relation to earnings, dividends, and asset value. Not every dollar of earnings is the same, and we want to emphasize companies with high-quality reported earnings. Moreover, companies have many ways to spend their money, and we favor those with disciplined capital deployment strategies. Furthermore, we want to own companies whose balance sheets support a sustainable enterprise. And finally, we believe there is information to be gleaned from recent stock price behavior, which can help us time our purchases and sales.

Having narrowed our focus, we will then utilize first-hand research to assess a company's fundamentals, including its competitive position, management capabilities, and earnings power. The research team's underlying focus will be on determining what the consensus is missing about the company and what catalysts exist to enable realization of fundamental value over time.

Exhibit 9: Investment Process for Large Cap Core



Once we have selected about 60 stocks from around the world, we will use our quantitative tools in conjunction with our best judgment to weight the holdings in a way designed to achieve lower volatility than the broader equity market, a helpful attribute in weaker market periods.

Q: What can we expect for Large Cap Core returns?

Stern: Over time, we believe this approach can outperform the S&P Global LargeCap Index — while providing additional protection in times like today when volatility is so substantial.

To be sure, the portfolio will not outperform every month, every quarter, or even every year. In particular, Large Cap Core may lag in periods when equity markets are temporarily surging. However, by seeking to lose less during market downturns, we believe Large Cap Core will be in a better position to outpace the broader equity market over full market cycles.

We will pair Large Cap Core with Large Cap Strategies.

Q: Will Large Cap Strategies also look to control volatility?

Stern: No, Strategies will not feature explicit volatility controls. Therefore, it will not likely protect as much as Core on the downside, but it should more fully participate in up market periods. That's why these portfolios are coupled within Bessemer's overall recommended allocation to large cap equities.

Q: Will Large Cap Strategies be volatile, then?

Stern: Only as volatile as equities in general. We expect the fund's volatility to be similar to that of the S&P Global LargeCap Index. One of the ways the fund will look to enhance the consistency of its returns is through the combination of three managers with starkly different investment approaches. The Bessemer team will focus on companies that are currently operating below their normalized earnings — taking into account multiyear operating cycles — but are improving.

Meanwhile, London-based Oldfield Partners will focus on companies selling at significantly discounted valuations, and Virginia-based Sands Capital Management will focus on companies with superior prospects for rapid growth.

All three have favorable long-term track records, and, even more importantly, they tend to outperform the equity benchmark at different times. Consider the performance of the two extremes, Oldfield and Sands. In each of the last 15 years, at least one firm outperformed. Combining managers whose relative returns differ substantially should deliver more consistent returns than those achieved by any one manager alone.

Q: Hedge funds came up earlier — aren't they known for generating either exceptionally good and bad returns rather than consistent returns?

Langas: Yes, hedge funds tend to get a lot of attention when some of them achieve outsized gains or losses. But in general, hedge fund returns have actually been less volatile than those of the broader equity markets. In fact, we believe hedge funds can play a role in dampening overall portfolio volatility.

Richards: Hedge fund returns are usually less volatile than those of stocks or bonds, so their biggest advantage is that they offer diversification and volatility-reducing benefits to a balanced portfolio.

However, in periods of severe market stress — as in 2008 and 2011 — hedge funds become more volatile and more likely to move in the same direction as the broader markets. In the most recent quarter, we saw hedge funds fall about in line with the S&P 500 Index, making it the fourth worst quarter for the asset class in the last 15 years.

Langas: Investors who made the mistake of replacing their high-quality bond allocation with hedge funds learned the hard way that the asset class behaves like other riskier investments in hostile markets. In such environments, bonds and cash are the only asset classes likely to protect and possibly appreciate.

Richards: One of the advantages that hedge fund managers have is enormous flexibility. When markets become erratic, they can quickly move into cash as a temporary safe harbor. Moreover, skilled managers will look to use volatility to their advantage by investing in assets that become attractively priced thanks to market pressure.

Q: Are some hedge fund strategies more volatile than others?

Richards: Yes. The following are some broad examples:

Relative value. This refers to funds whose strategies are designed to produce returns independently of the broader market, such as market neutral, convertible arbitrage, and fixed income arbitrage. For instance, equity “market neutral” funds may buy one type of security (such as Wal-Mart stock) and short a similar one (such as Target), believing that the market will reward the stock price of the stronger company and depress the stock of the weaker company. A relative value manager seeks to outperform from both its long and short positions, and the fully hedged approach tends to generate a less volatile return stream than the broader markets.

Event-driven. Managers with these strategies position their portfolios to benefit from significant corporate events, such as hostile takeovers, mergers, and bankruptcies. Some seek to invest in distressed companies selling for far less than their intrinsic values. Event-driven strategies tend to have low to moderate exposure to the broader markets, positioning them toward the middle of the risk/return spectrum.

Opportunistic. These strategies often involve taking on greater exposure to the market, potentially leading to higher — but more volatile — returns. One example may be an emerging-market fund, whose approach to investing is more long-biased because it faces greater difficulty in executing a short strategy. Other examples include long/short

equity funds, short sellers, macro funds, and sector-specific funds.

Q: Within Bessemer's hedge fund program, how do we look to control volatility?

Richards: We combine hedge fund managers with diverse and complementary strategies. Exposure to a range of geographies and sectors gives us additional diversification benefits.

Moreover, we do not rely on leverage to drive portfolio returns; instead, we rely on manager skill. The heavy use of borrowed funds can magnify losses when the market moves against a strategy. Bessemer's funds of funds are not levered, and we maintain only modest exposure to leveraged strategies within the overall portfolios.

We're convinced that a well-diversified hedge fund program — one that emphasizes the selection of skilled and reputable managers through extensive research — can deliver solid risk-adjusted returns over full market cycles and help to reduce the volatility of an overall portfolio.

Q: So what's the most important takeaway for investors when it comes to harnessing volatility?

Langas: The two best means for guarding against volatility are diversification and proactive investing. Constructing a portfolio of diverse asset classes — from bonds to stocks to commodities — allows investors to generate more consistent returns. Bonds in particular offer significant ballast to a diversified portfolio when market stresses become extreme. But diversification alone isn't enough; in changing markets, it's important to have a proactive approach because it gives investors the flexibility to shift asset class weightings and investment strategies as new developments unfold.

Finding the proper balance between risk and return ultimately comes down to an investor's individual objectives and the amount of risk he or she is willing

to take to achieve them. Periods of heightened volatility can be unsettling, but it is important not to let emotions overtake the decision-making process. Sticking to a thoughtful long-term plan and disciplined investment approach is essential.

Though disruptive in the short term, volatility can be good for long-term investors. By reflecting fluctuations between investor greed and fear, volatility can open up substantial investment opportunities — such as owning attractive assets at discounted prices — that wouldn't be available otherwise.

So our goal is to harness volatility by limiting the downside clients experience and taking advantage of the opportunities created in turbulent times.

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