



SPRING 2010

FIDUCIARY PERSPECTIVE

INSIGHTS ON PRIVATE WEALTH MANAGEMENT

Celebrating
125 years
1885-2010

A NOTE FROM OUR PRESIDENT

In 2010, we are celebrating our 125th year as an independent firm. We began as a family office in 1885 and became incorporated as Fiduciary Trust Company in 1928. Since our opening, we have focused on preserving and growing wealth for high net worth individuals and families.

We have adapted to the challenges of diverse economic climates and financial market extremes. We have served many families for three generations or more. Almost half of our accounts have been opened in the past ten years which exemplifies our ability to meet the demands of today's sophisticated investors.

We are proud of our heritage and our success for the past 125 years and we are enthusiastic about serving future generations for many years to come.

Doug Smith-Petersen
President & CEO

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SELECTING INVESTMENT MANAGERS

Selecting investment managers is essential to implementing the concept of open architecture, a topic that was reviewed in the Winter 2008 *Perspective*. At its simplest level, open architecture provides investors access to top-tier investment managers. Fiduciary Trust Company's (FTC) independence enables us to make investment recommendations without the conflicts of interest seen as inherent with many other advisors. Open architecture permits us to work with our clients so that their interests and our interests are closely aligned.

As numerous studies have demonstrated that asset allocation is the primary determinant of a portfolio's performance, open architecture is critical to implementing a diversified portfolio. We are acutely aware of the incremental fees associated with allocating capital to managers within a broad range of asset classes. Our entire approach to incorporating additional asset classes within a client's portfolio is done from the perspective of the incremental improvement in the portfolio's risk-return profile, net of fees and expenses. FTC has embraced open architecture, and the empirical evidence has shown that our clients have benefited tremendously.

The goal of this article is to shed light on the process that FTC undertakes to implement open architecture by identifying, selecting, and monitoring investment managers. Investment managers, whether passively managing to closely track a market index or actively managing to outperform a market index, are the critical components necessary to implement the diversified asset allocation guidance recommended by FTC's Investment Committee.

The Initial Due Diligence

FTC's investment manager due diligence process is managed by the firm's Alternative Investment Committee (AIC), which is comprised of six of FTC's senior investment professionals. Additionally, the firm's Investment Committee oversees the AIC's efforts to ensure that there is a consistent and coordinated investment process. Once the Investment Committee determines the appropriateness of adding an asset class, the AIC is charged with establishing how best to allocate to the asset class. The AIC's investment manager evaluation and selection process strives to identify managers who have consistently delivered superior risk-adjusted investment results and who are capable of continuing to add value going forward.

The process begins by establishing an agreed upon proxy or benchmark for the desired asset class. For example, the Russell 2000 Index may be considered the appropriate benchmark to represent the universe of small-cap U.S. equities. After identifying the appropriate benchmark, the AIC determines whether to use a passive strategy, such as a Russell 2000 Index Fund, or to select active managers who have shown a quantifiable consistency of delivering superior risk-adjusted returns versus the benchmark. One measure considered is alpha. Simply stated, alpha is a measure of risk-adjusted excess return of a manager above a targeted benchmark. Assuming risk characteristics similar to the benchmark, a positive alpha of 1.0 means the manager has outperformed the benchmark index by 1%.

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FIDUCIARY TRUST

DON'T BLINK

Much of the economic recovery over the past year has been discounted or dismissed. The credit-induced euphoria of 2006 and 2007 morphed into the distress of the 2008–2009 financial crisis before moving to the chastened and twice-shy investor of today. Today's "giant error of pessimism," which we discussed last year, still clouds investors' thinking. This may make it difficult to correctly assess the soon-to-be-shifting economic ground and to target opportunities going forward.

This recovery has done some heavy lifting. Those who have exposure to the financial markets have benefited, as cash has flowed into the markets. The S&P 500 is up 70+% from a year ago. High-grade corporate bonds have rallied by 11%. Exports have expanded, fueled by our competitively priced currency and a growing overseas demand for our products. The industries favored the most have been in our manufacturing-related sectors, including technology and industrial production. Credit market activity has picked up, with corporate bond issuance recently seeing its best weeks since two years ago. Employment is better, but the improvement is not yet broad or deep.

All is not well. Last cycle's leaders are often this cycle's losers. In Warren Buffett's words, "You get to see who is not wearing a bathing suit when the tide goes out." Many enterprises were living on too much debt and were truthfully uneconomic. Housing, construction, selected finance and manufacturing, and residential and commercial real estate industries are all still hurting and employment will not recover for many months or years.

The multiple structural issues of the U.S. economy are not healed either. Unless the U.S. brings its spending and its revenues more in line, we expect poor prospects for growth and an anemic economy over the next several years due to surging levels of government debt.

Unexpected Positive Surprises Today

As 2009 drew to a close and 2010's first quarter has unfolded, the economy's strength has surprised many observers. What is the source of this positive surprise? We need to look back to the fall of 2008 to find the seeds planted for today's recovery.

As you can see from the graph to the right, in October 2008 the Federal Reserve (the Fed) expanded the U.S. money supply dramatically as measured by the monetary base,

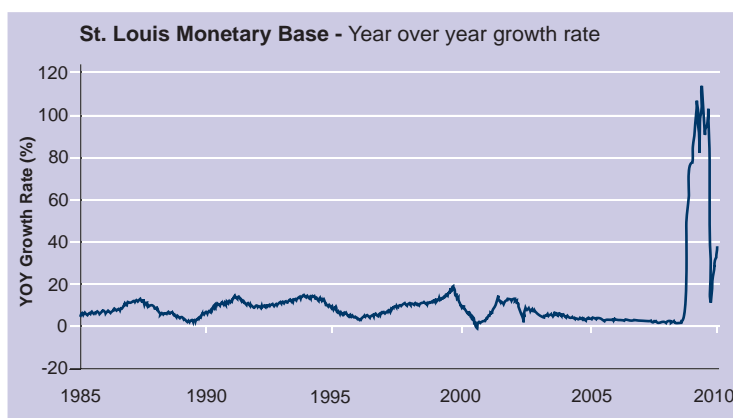
dwarfing any central bank action taken in the Fed's history. The monetary base is now \$2.3 trillion, up from less than a trillion dollars in 2007. In the matter of a few months in late 2008, the balance sheet of the Fed expanded by over 100%, or by over a trillion dollars, as the Fed bought up assets from banks, insurance companies and institutional investors. The Fed paid cash for the assets, thus pumping a huge amount of liquidity into the economy within a very short period of time. Think of this as providing fuel for future economic growth.

This was coordinated globally because many world markets sold off precipitously prior to October 2008. Central banks, whether in Europe, the U.K., or China, took similar measures at the same time. The stage was set for a synchronous global market rally, which started in March 2009, one to three quarters after the liquidity was injected. The response lagged because it took time for the liquidity to percolate through the system and begin to express itself in higher market values.

In the U.S., the Fed also launched several innovative programs in order to cause the U.S. money supply to grow further. The Fed began to purchase mortgage-backed securities in early 2009 and helped financial institutions reduce their real estate exposure. These purchases lowered interest rates on mortgage-backed bonds by an estimated 0.4% to 0.6%, thereby stimulating real estate activity and supporting home purchases. Fearing potential inflation, the Fed ended this program after March 2010.

A Slowdown on the Horizon

Look again at the graph. After the first meteoric rise in the size of the Fed's balance sheet, the growth rate began to slow down. Its growth was still positive, but not as fast as before. Then, as 2009 drew to a close, the rate dropped abruptly from almost a 90% growth rate year-over-year to about 20% growth. This reduces the fuel, slowing future economic growth.



Source: Federal Reserve Bank

Cutting the growth rate of the U.S. money supply from 90% to 20% over a few months while at the same time exiting other innovative Fed programs means that in a few quarters, our economy's growth rate may also begin to slow. Long-leading indicators suggest that this slowdown may be synchronous with economic slowdowns in continental Europe, the U.K., and even the Asia-Pacific region.



NEWS AND NOTES

The fixed income market itself acts as a governor on the economy. Investors demand higher rates to compensate them for the risk of expected future inflation. These higher rates on longer-dated bonds may further dampen future economic growth.

Will Inflation Go Away?

The Fed realizes that expanding the money supply is ultimately inflationary. It must begin to withdraw liquidity from the market in order to reduce inflationary pressures. It is a balancing act to shrink such a huge balance sheet in an orderly way: if it is done too quickly, it causes another recession; if it is not done soon enough, it will cause inflation. Other central banks, such as those in China, India, and Australia, are also concerned about potential inflation and have begun to tighten.

We have been concerned about higher inflation for over a year now. There are three major sources of this inflation. The first is the growing demand for commodities from the emerging markets. We already see this outcome. The price for scrap steel, for example, has risen by almost 35% from a year ago. If the emerging markets' growth rates slow, these inflationary pressures may diminish, but still persist. The second source is the growth in the money supply, which we discussed in the preceding paragraphs. Unless the Fed takes the growth rate negative and shrinks the money supply, its growth will exert inflationary pressures over the next few years. The third source is the growth of federal expenditures as a percentage of GDP. Since government produces few goods, it causes more money to chase the same number of goods, thus driving up prices. These three factors are very dominant issues today.

As Our Economy Slows, Structural Problems Will Gain in Dominance

A strongly growing economy can hide many problems and blemishes. A slowly growing economy reveals these problems. Our federal and local deficits are large and expanding to levels that will challenge our ability to even pay the interest on them. Consequently, our interest rates are expected to rise as we have to issue more debt and entice investors to buy it. This will hurt the value of our dollar, especially versus emerging markets, many of which are creditor nations. Taxes will also need to rise. Rising inflationary pressures will also be a drag on the economy. All these retard economic growth for the U.S., making it more difficult for our economy to bring down the oversupply of housing or reduce the unemployment rate. With a sub-par economic growth of perhaps 1% to 2% GDP and a stubbornly high rate of unemployment, we will not grow our way out of the mounting deficits and rising debt.

Protecting Capital in an Adverse World

These conditions require a thoughtful approach. High-quality U.S. equities that are focused overseas are potentially attractive. Overseas equities, especially in the emerging markets, may hold greater promise due to the broader opportunities for growth outside of the U.S. Within fixed income, we believe it is important to keep bond maturities, whether individual bonds or in funds, very short. This protects against the negative effect of rising interest rates. We believe that international bonds should play a central part of client portfolios. In the world of alternatives, real estate, timberland, commodities, and gold play an important role as inflation hedges. Finally, the mutual-fund based hedge funds we have used over the past several years are very important for reducing portfolio volatility and taking advantage of market dislocations in distressed securities. ■

○ | **Brent Henry Joins Fiduciary Trust's Board of Directors**

We are pleased to announce that Brent Henry joined Fiduciary Trust's Board of Directors in February. Mr. Henry is Vice President and General Counsel of Partners HealthCare, an integrated teaching, research, and health care delivery network based in Boston with more than 45,000 employees. At Partners, he oversees both the legal department and corporate compliance.

Mr. Henry is a past President of the American Health Lawyers Association and a member of the Board of Directors of the New England Council, the New England Legal Foundation, and the Public Welfare Foundation. He is also a Trustee of the Boston Symphony Orchestra and an Emeritus Trustee of Princeton University. With his years of legal experience and board service, Mr. Henry is a valuable addition to our board.

○ | **Bob Holdway and Charles Platt Named 2010 Five Star Wealth Managers**

Fiduciary Trust's Bob Holdway and Charles Platt were both named Five Star Wealth Managers in the February issue of *Boston Magazine*. The awards are based upon the results of a survey of high net worth individuals and are given to those professionals with the highest overall client satisfaction. The Five Star designation is awarded to less than four percent of wealth managers in the Boston area.

○ | **Launch of Enhanced Private View™**

In the second quarter, we will be launching an improved version of Private View™, our online client tool. In addition to having a new look and feel, this enhanced application will be compatible with a broader range of browsers and computers, including Macs. Private View™ will also now have expanded graphics and stronger security features.

Current users of Private View™ will receive additional details about the conversion in the coming weeks. For those who would like to learn more about registering for Private View™, please contact your investment officer.

SELECTING INVESTMENT MANAGERS *(continued from page 1)*

Correspondingly, a similar negative alpha would indicate an under-performance of 1%.

Once the appropriate benchmark has been identified, the AIC begins a quantitative screening process that ranks the available universe of investment managers by several measures, including alpha, correlation, and down-side risk versus the benchmark. Manager performance data are available for a nominal fee and are an easily accessible commodity presented in a consistent, industry-standard format by a multitude of providers. Gathering the data for the universe of small-cap U.S. equity managers is a straightforward task, but the key is how one analyzes, interprets, and utilizes the data in order to make decisions.

The Quantitative Analysis

An important element to be aware of is our use of rolling-period screening. We are not solely interested in how the manager has performed or ranked over the past 3-year period through the end of 2009. Instead, we are focused on how managers have performed over EVERY rolling 3-year period since their inception. For example, if a manager's inception was January 2004, it would have 37 rolling 3-year periods of data to analyze as of the end of 2009. Therefore, each month after the initial 3-year time period (which ended in December 2006) would present another 3-year period to analyze. We are interested in the persistency of manager performance and not simply the end-point specific nature of how they did over the past three years, which can be misleading.

Examining rolling-periods eliminates a phenomenon called "end-point sensitivity" or "end-point specific" performance, namely the likelihood that conclusions drawn from returns will be distorted by the most recent market environment. A finite period approach can make it difficult to assess whether a manager's returns stand out because of superior investment acumen or simply because a manager's investment style happened to be in favor during the observation period.

The Qualitative Process

After various rolling performance and risk screens, we are able to rank and narrow the available opportunity set down to a manageable number ranging from 10 to 40 managers. From that group we begin our qualitative due diligence. Many factors, such as the level of assets under management, turnover within the investment team, and industry reputation, allow us to pare down this list fairly quickly.

Once the group has been narrowed down to approximately three to five managers, we begin a more comprehensive review. We conduct in-depth style analysis to ascertain consistency of portfolio construction and risk management over time. This helps us uncover changes in investment style over time, such as a small-cap manager allocating to large-cap stocks or a value manager owning a large percentage of growth stocks. Next, we request a completed due diligence questionnaire, which is a lengthy document outlining the organization, people,

process, philosophy, and performance of the manager being analyzed. We also review all relevant regulatory filings for any inconsistencies or concerns. From this point, we determine if we will continue our due diligence and request a meeting or conference call with the key investment team members.

During the manager meeting, we look for consistency of the investment team, process, and philosophy over time. We want to know how investment decisions are made by walking through several examples. What decisions worked and, more importantly, have not worked? What has the manager learned from these decisions? Having a thorough understanding of the manager's philosophy and how it is executed is essential to our gaining confidence in the manager. The goal is to build the case and have the conviction that all elements are in place for the manager to continue to execute in a consistent manner going forward.

The Ongoing Monitoring

Once the AIC has made a recommendation to allocate to a manager, the process has only just begun. Arguably, the more challenging endeavor is monitoring the manager. Prior to the final approval of a manager, the AIC establishes a set of Investment Manager Guidelines, which clearly articulates the rationale for approving the manager and establishes our expectations for the manager from the outset. The guidelines serve as a critical monitoring tool to identify when a manager has deviated from our expectations. Manager guidelines identify strengths and weaknesses of each manager's strategy, what market environment(s) we would expect their strategy to be in or out of favor, and a range of benchmark relative return expectations. This helps us to avoid falling in love with great performing managers or, conversely, prematurely losing patience with poor performance. Having a well-defined set of guidelines and expectations is critical to making sound investment decisions and to avoiding knee-jerk, hasty decisions.

Conclusion

Although no process is infallible, the key to successful long-term manager selection is having a rigorous, formalized process. The requirements have never been more challenging than they are today, as the investment management industry is increasingly dynamic, with portfolio manager turnover, firms merging, and new investment ideas developing rapidly. It is imperative to have a sound, disciplined process in order to effectively select and closely monitor investment managers for consistency of philosophy, strategy, personnel, and performance in the ever-evolving investment landscape. ■

Christopher D. Cabral, CFA, Vice President

If you are interested in obtaining a copy of the "Open Architecture" piece mentioned in the beginning of this article, please call your investment officer or go to our website, fiduciary-trust.com, and click on Approach to Investing, then select Open Architecture.