INVESTMENT SPOTLIGHT

BONDS, REAL ESTATE AND PRIVATE EQUITY

Three distinct investment approaches look for opportunities in a singular investment environment.

BY IAN PRIOR, *U.S. Trust*

THE GOAL OF INVESTMENT SPOTLIGHT is to familiarize our clients with investing options available from U.S. Trust. In this issue, we present edited interviews with Edward W. Turville of Real Estate Management Services Group, Ben Ault of Grey Mountain Partners and Michael Hasenstab of Franklin Templeton Investments. If you would like more information on these or other funds, please contact your U.S. Trust advisor.

REAL ESTATE MANAGEMENT SERVICES GROUP, LLC

Edward W. Turville

We look across the public arena of equities in real estate and try to acquire assets at a distinct value relative to the private market. Our investment process identifies companies with long-term appreciation potential, and we acquire equity positions in them, including preferred positions in the capital structure. We seek to maximize dividend returns in the portfolio so we always have capital to reinvest, and because the reinvestment of income paired with the increase in value is what allows us to achieve our return objectives.

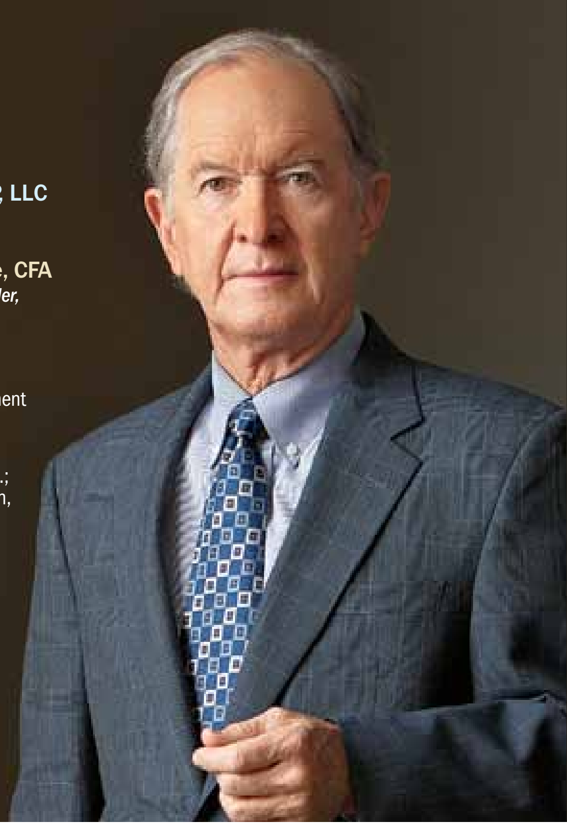
How is this real estate cycle different? In the past, market corrections tended to occur for essentially the same reasons: too much leverage and overdevelopment. This time around, although there's a limited inventory of vacant new development — a relative scarcity that would ordinarily lead to higher prices — the pace of the economic recovery is well below historical patterns. Asset classes, including real estate, have become more correlated to other financial markets, and more volatile, than in the past. Also, our business is now more prone to outside shocks — the sovereign debt crisis, for instance — that have nothing to do with the underlying economics of the real estate business.

How are you adapting? The value matrix of investing in commercial real estate has remained more or less the same in terms of "cap" rates, cash flows, replacement costs and the like. But as external shocks periodically correct valuations in both private and public markets, there is the opportunity to acquire assets at discounted values. At the same time, because the economic recovery is so much more gradual, even with less supply, it will probably take certain property types much longer to reach their full potential.

THIS TIME AROUND, REAL ESTATE HAS BECOME MORE PRONE TO OUTSIDE SHOCKS AND IS MORE VOLATILE THAN IN THE PAST.

What does that mean for the different sectors of commercial real estate? Toward the end of 2010, the recovery was happening more quickly in the hotel and apartment markets — where we were well positioned. We are now working our way more gradually into retail, office and industrial assets. Basically we are capturing different pieces of the recovery as they unfold.

How about debt restructuring in commercial real estate? Because of the kind of recovery we're having, as well as the imminent maturity of large amounts of financial leverage that occurred



REAL ESTATE MANAGEMENT SERVICES GROUP, LLC

Edward W. Turville, CFA
Portfolio manager, founder, managing partner, chief investment officer

Specialty
Real estate and investment

Career
Formerly with Beach Investment Counsel, Inc.; Dalton, Greiner, Hartman, Maher & Co.

Education
CFA, graduate of Rice University, advanced degree in accounting

Resident
Naples, Fla.

Hobbies
Golf, tennis and fishing

GREY MOUNTAIN PARTNERS

Ben Ault
Vice president

Specialty
Middle-market buyouts

Career
Formerly Goldman Sachs M&A; joined Grey Mountain in 2004

Education
Master's degree from the London School of Economics; B.A. economics and management, Indiana University

Resident
Minneapolis

FROM LEFT: JEFFERY SALTER, AMY ECKERT

between 2005 and 2007, we think it will be very opportunistic to own pieces of the process of restructuring that debt. We are doing this by acquiring real estate investment trusts (REITs) that deal specifically with commercial mortgages.

What about leverage? We have generally not been aggressive users of portfolio leverage, and several years ago we significantly reduced the amount of leverage in the portfolio. However, now that a correction in the real estate market is finishing, and there is lower risk involved, we have at times used leverage to gain more upside.

What is your approach to risk management? We have a risk-control monitor that looks at the rate of change of pricing in the REIT index market relative to normal bands of valuation. When prices reach the upper levels, we will tend to become more conservative and sometimes establish short positions. At the lower levels, that might be a time we would use leverage.

What do you foresee for the rest of 2011? In general, the market environment for commercial real estate is good. One driver of higher prices is low interest rates. Higher rates this year would affect the market. We see dividends rising again, particularly in REITs; we also think occupancy and cash flows will continue to improve. We are seeing the beginning of positive changes in the industrial and suburban office markets, in which we don't foresee much new supply for years.

GREY MOUNTAIN PARTNERS

Ben Ault

We try to create value by improving the profitability of the companies we invest in, as opposed to relying on market timing or financial engineering. Additionally, we need to create value systematically, regardless of fluctuations in the broader economy. In practice, we acquire majority interests in companies that have attractive underlying fundamentals but also have room for operational improvement. We then focus on the three principles we view as critical for success in these businesses: good people, good information and basic discipline. Our goal is to achieve continuous operational improvement to create lasting value.

> WE FOCUS ON THREE PRINCIPLES CRITICAL FOR SUCCESS: GOOD PEOPLE, GOOD INFORMATION AND BASIC DISCIPLINE.

What sort of businesses do you work with? We focus on basic industries, allowing us to control as many risk factors as possible, thereby amplifying the impact of our value-creation initiatives. We do not place bets on macroeconomic trends, technology adoption rates or consumer preferences — all things we cannot control. In general, we look for companies with revenue greater than $30 million or earnings before interest, taxes, depreciation and amortization (EBITDA) of more than $5 million, and we specialize in situations such as entrepreneurial and familyowned companies in need of a succession plan, corporate divestitures, operational turnarounds and financial restructurings.

Tell us about those three areas of focus. First, getting a strong management team in place is the most reliable means to creating lasting value. Next, it is imperative that managers have access to high-quality information in order to make good decisions. Third, basic discipline involves developing a culture of continuous operational improvement so that the company can systematically optimize its operations and respond to opportunities and changing conditions.

How do you work with management teams? We emphasize transparency in terms of our motivations and goals. Sharing that information, along with providing properly structured incentive plans, creates a situation in which the management team's goals are closely aligned with our own. We encourage management teams to develop fast-paced but realistic business plans, and then we do everything in our power to support them and help them achieve those goals. We are available to our management teams 24 hours a day.

When do you decide to sell a business? The goal is always to buy low, create value, then sell to the most logical buyer. So we have a very process-driven, methodical approach for exit decisions. If we have met or exceeded our capital appreciation expectations, we look to exit the investment. We want to capitalize on our competitive advantage, not allow inertia or a lack of institutional discipline to distract us.

How long does this process take? The time line really does vary. We view due diligence, before we invest, as the time to develop a value-creation road map that lets us hit the ground running. But some operational improvement initiatives simply take longer than others — not only to implement, but also for them to generate benefits in terms of increased profitability. Historically, we have underwritten most investments based upon a five-year road map, but more often than not, businesses improve more quickly than we expect. So it usually takes between two and four years.

What is your approach to risk management? It could probably be summed up by saying "be wary of the risks that are beyond your control." By investing in basic industries, using leverage cautiously and not betting on our ability to time the market, we are able to focus on our competitive advantage — systematically creating lasting value at the companies we invest in. The risk in this model is execution, which is a risk that we can and do control.

What do you see for 2011 and beyond? Many businesses have been hit hard by the recession and are at or near all-time lows in terms of performance and valuation. This presents a great buying opportunity. Long-term, we are focused on the right space. Not only is our operational improvement-oriented approach an evergreen strategy that should perform well throughout economic cycles, but the underlying drivers of lower middle-market M&A activity indicate a robust market environment for decades to come.

A STRONG MANAGEMENT TEAM IS THE MOST RELIABLE MEANS TO CREATING LASTING VALUE.

FRANKLIN TEMPLETON INVESTMENTS

Michael Hasenstab, Ph.D.

We invest predominantly in bonds of governments and government agencies around the world. We actively manage the fund's exposure to currencies, interest rates and sovereign credit to help us maximize risk-adjusted returns. We differ from most global bond funds in that we build the portfolio independent of any benchmark.

Why that approach? One reason is that the appropriate benchmark, JP Morgan Global Government Bond Index, is invested primarily in four areas: the Eurozone, the United States, Japan and the United Kingdom. Because it is so concentrated, investing close to the benchmark can add risk to a portfolio rather than provide diversification.

How do you diversify? We try to get significant diversification geographically, so we're invested in about 30 countries and 20 currencies. In general, the way these markets perform tends to be very different from what happens in U.S. Treasuries, corporate bonds or equities. So you get true diversification, which has helped this strategy gain traction over the long term. We also may diversify by making strategic investments based on interest rates, sovereign credit markets and currencies.

How about your research process? We have a large research team — 40 people — providing investment ideas from major locations worldwide: Dubai, London, Mumbai, New York, San Mateo, São Paolo, Seoul, Shanghai and Singapore. I also spend a lot of time traveling, meeting with policymakers, business and political leaders, and academics.

Tell us about the current market environment. We favor short-maturity bonds in such places as Australia, Israel and South Korea. These positions offer yields of 3% to 5% for less than two years of duration exposure and what we consider to be little sovereign risk. While these bonds carry currency risk, we think the currency exposure could further enhance return potential.

What's your view on emerging markets? The underlying causes of the financial crisis were not present in many emerging markets; consequently, once liquidity returned to capital markets, they were able to quickly return to precrisis growth rates.

FRANKLIN TEMPLETON INVESTMENTS

Michael Hasenstab, Ph.D.
Portfolio manager, co-director

Specialty
Global macroeconomic analysis

Career
Joined Franklin Templeton Investments in 1995

Education
Ph.D. in economics; M.A. in economics of development; B.A. in international relations/political economy from Carleton College

Resident
San Mateo, Calif.

Hobbies
Travel and mountain climbing

COURTESY OF FRANKLIN TEMPLETON INVESTMENTS

We think the fundamental drivers of long-term growth in emerging markets have remained intact, as evidenced by strong recoveries in investment and consumption. Tighter fiscal and monetary policy, the end of inventory rebuilding, and weak demand for exports to the G-3 may result in somewhat lower growth rates in early 2011 than these markets experienced at the height of the recovery in 2010. However, we think growth moderating to more sustainable levels is a positive development over the long run.

Fears of a hard landing in China and other emerging markets were drastically overstated, and we expect emerging markets to continue to lead the global recovery, based on data from the International Monetary Fund.

FEARS OF A HARD LANDING IN CHINA AND OTHER EMERGING MARKETS WERE DRASTICALLY OVERSTATED. EMERGING MARKETS WILL CONTINUE TO LEAD THE GLOBAL RECOVERY.

Who provides risk oversight on the portfolio? We have a large risk-management team, independent from our portfolio managers, that constantly reviews the portfolio's risk exposures. Additionally, there are multiple levels of management oversight, including peer reviews, CIO evaluations and board meetings. A lot of eyes are looking at what we're doing.

What do you see as a major theme in 2011? We think interest rates generally will rise in 2011, both in fast-growing emerging markets and in the developed world, where rates remain at historically low levels. Even in the United States, where we expect the recovery to be moderate, we believe improving economic activity will combine with the historically large financing needs of the public sector to push up yields. We are positioned not only to be cushioned from rising yields but to capitalize on them. This involves both limiting duration exposure in most economies and using currency and other exposures to position ourselves to benefit from rising rates. In the current global environment, investors must diversify internationally in order to earn high yields without taking on significant duration risk. CA