EXECUTIVE SUMMARY

Investment Strategy Overview

DECEMBER 2011

This report summarizes U.S. Trust's investment outlook. To receive a more in-depth report or to discuss this information in light of your particular investment objectives, please contact your U.S. Trust advisor or log on to ustrust.com/accountaccess.

2012: The Year the Can Kicks Back

The New Paradigm Enters the Final Stages

Next year, we believe that the "markets" will finally pressure policymakers to move beyond temporary half measures and make substantive fixes. In other words, the "can" that policymakers have been kicking ineffectually down the road for the past few years may finally kick back and compel positive long-term structural change.

That said, we believe we're facing another year of sharp market volatility and a continued short supply of quality yield. We are prepared to lower market risk and cyclical exposure in portfolios during periods of positive sentiment and allocate more to higher-yield, cash flow-driven and dividend-based strategies. At the same time, we will continue to position portfolios to take advantage of opportunities that appear likely to benefit from the global rebalancing theme, which should remain the dominant driver of performance over the long term.

We're forecasting the S&P to finish 2012 around 1300 to 1350, based on profit of close to $100 per share for the year, slightly higher than the profit numbers for 2011. Our market range for 2012 is still wide at 1150 to 1350, though again slightly higher than in 2011.

> The "markets" should pressure policymakers to make some meaningful fixes, but the near-term investment environment should remain fragile.
>
> — Christopher Hyzy
>
> *Chief Investment Officer,* U.S. Trust

THE NEW PARADIGM

The credit crisis brought a new paradigm in its wake, and it affects virtually everything from commerce to geopolitics; it affects the way businesses operate and the way we conduct our personal lives and finances. Basically, we are all—in one way or another—repairing the bloated debt structure of the last few decades. This repair process requires structural change, and that is what's happening around the world right now. In the emerging markets, we're seeing an expansion of balance sheets and the creation of a middle class. In the developed world, it's the exact opposite. In the developed world, we are restructuring

Highlights

- Potential policy fixes ahead, but also continued uncertainty, volatile market conditions, and an ongoing short supply of quality yield.
- We are trimming back risk but maintaining our current equity/fixed income balance as valuation still favors equities. Yield-tilt and low volatility strategies are our top 2012 themes across asset classes.
- Emphasize U.S. large cap multinationals, global companies growing dividends, technology and industrials, protection strategies, and global long/short opportunities.

our balance sheets and deleveraging, paring down liabilities and repairing our capital structure so we can create a new base from which to grow. This is all part of the long-term global rebalancing theme—that is, the shifting of growth from the developed to the developing world—that we've been talking about for the past few years.

This repair process has made for high degrees of uncertainty and challenging market conditions, and 2011 has proven particularly challenging for equities (the S&P 500 had approximately a 24% range during the year) and global credit spreads (European bond yield spreads hit euro-area record highs during the year). It was an extreme "binary outcome" year with sentiment changing dramatically seemingly every other week. Policy concerns took control over the summer, as the world waited for the Super Committee to fix the budget deficit in the U.S. and for European policymakers to bring in the "big bazooka" to address their mounting problems. Unfortunately, 2011 has proven to be a year of words rather than concrete action. We believe it's time for more action on long-term structural change.

2012: PAYBACK TIME FOR POLICYMAKERS

In 2012, we believe that the economy, the markets, and investors will finally force policymakers to make substantive fixes. Meanwhile, we believe we're facing another year of sharp volatility, dictated by the policy-heavy climate. Expect a switch in policy focus from Europe back to the U.S. as the presidential election takes center stage and adds to the policy clouds that appeared in the summer of 2011 and darkened with the Super Committee week in November. But the European debt situation—whether it's fixed or not—should remain a "pressure valve" that the market will be watching closely.

We expect these themes to play out as follows: Early in 2012, the European recession should become more apparent across the globe. Consensus profit estimates should be adjusted lower and the housing and government sectors should remain in repair mode. Resulting negative market volatility should be offset by continued solid profits overall, easier monetary policy in the emerging markets, and improving U.S. job growth.

When we put this all together, we believe we'll get a year that begins with some positive momentum, based on better economic and job growth in the U.S., potential enthusiasm over Europe "moving in the right direction," and portfolio positioning that began prior to year end. After that, we expect the European economic recession to become more visible, and that should filter into the industrial and technology sectors globally, causing consensus estimates to be lowered. (Current consensus estimates for U.S. profits in 2012 are $108 for the S&P 500; we're looking for $97 to $99.) At the same time, China slowdown fears should gather momentum once again, and the U.S. campaign season should take off in earnest with its destructive class warfare theme.

This dynamic is likely to weigh on the market as we head into the second quarter. Decent U.S. job growth and more accommodative emerging market monetary policy led by China and Brazil should mute some of the negative pressure from what we expect will be fractious presidential debates. However, a further bite from Europe's downturn, skepticism over its long-term structural plan, and higher U.S. housing inventories (based on the release of foreclosure backlogs) could spark another market downturn in the summer months similar to 2011 and 2010.

We expect the market to end 2012 in an upswing. As we head into the fourth quarter, the market should start to digest the election outcome in the U.S., economic improvement in the emerging markets as monetary stimulus takes effect, and perhaps a final debt resolution with full European Central Bank (ECB) involvement (the "real bazooka" we've been looking for).

In terms of our forecasts, we started 2011 with a target of close to 1400 for the S&P 500, which we lowered to 1300 in early August, as we believed policy would remain the major cloud over fundamentals for the next 12 months. At that point, we established a wider range of 1100 to 1300 (from1300 to 1400, based on the political overhang) for the remainder of 2011.

Our view remains largely the same now. We're looking for the S&P to close out 2012 around 1300 to 1350, as we expect the S&P 500 to produce a few dollars more in profits next year. Our expected range is still wide but slightly higher at 1150 to 1350. (To head to 1400 and higher, we would need to see a better policy climate, less impact than expected from the European recession, and portfolio flows into the U.S. financial sector.) So 2012 is likely to hold the same pattern as 2011, with bouts of sharp volatility but with slightly higher targets.

PORTFOLIO CONSIDERATIONS

Whether the S&P 500 closes 2012 at 1200 or 1400, the active anchor theme in portfolios should still overwhelmingly be the short supply of quality yield. So, for 2012, we are emphasizing active management around this dynamic coupled with an overlay of growth stories/thematic opportunities in various corners of the world.

Within this context, we are continuing to remove market risk and lower cyclical exposure during periods of positive momentum closer to the upper end of our ranges. We also expect volatile episodes to present opportunities to improve portfolio yield through rebalancing within each asset class to more fundamental-driven strategies. These adjustments are designed to achieve a more effective risk balance over time and allow for portfolios that are less sensitive to market movements while allowing cash flow and yield-tilt strategies to be the primary driver of total return.

At the same time, we will continue to position portfolios to take advantage of opportunities and themes that appear likely to benefit from global rebalancing, which is still early in a long-lasting cycle and stands to be the dominant driver of performance over the long term.

Regarding the various asset classes, U.S. **equities** should outperform most major markets, including the Eurozone and Japanese markets. We remain underweight international developed equities, but we are still positive, on a relative basis, on emerging market equities for balanced portfolios. From a sector standpoint, we continue to prefer technology, and industrials and certain consumer staples, although some companies in these sectors are vulnerable to the expected European recession.

Within **fixed income**, we continue to emphasize corporate bonds and are more favorably inclined toward high yield. In the tax-exempt space, we prefer high-quality municipals (essential-service revenue bonds and general obligations of states and high-quality local governments). Treasuries have been and should remain the sovereign bond market of choice for government market investors, in our view, even with the rating downgrade this year. However, we prefer corporate bonds and high-quality municipals versus Treasuries for the yield pickup.

Within **hedge funds**, we prefer to focus on managers of diversified strategies who invest in liquid securities, understand the drivers of balance sheet repair around the world, and use leverage responsibly. However, there will likely be opportunities for more opportunistic strategies that can complement the long-only equity portfolio. We also continue to add to "all-asset" managers as a replacement for equity-only managers in order to lower overall market risk.

As for **private equity**, general partners are reporting an increasingly competitive landscape. We recommend vintage year diversification among managers who have a strong track record in the full private equity cycle over multiple market cycles, from fundraising to deal sourcing to exit strategies.

On the **tangible asset** side, commodities are vulnerable to the recession "winds" blowing from Europe and a cyclical slowdown in China. As a result, we are lowering our allocation across our strategies by 2% to 5% and moving the allocation to cash. We are still long-term bulls on the asset class, however, and will look for more attractive valuation levels to increase our tactical weightings again. This is likely to happen over the summer, when we expect volatility to be at its highest. Long-term investors should consider non-directional commodity investments at this stage in the commodity cycle, as well as farm and timber assets for those who can accept some illiquidity. Finally, we still view precious metals, led by gold (although it has not reacted well in this latest market downdraft) and silver, as a hedge on rising risks, particularly the instability in the European financial system.

As for **currencies**, our macro view implies that the dollar has upside against the euro and yen. Global rebalancing provides the most scope for select emerging market currencies with high surpluses to rise against the dollar.

Residential **real estate** is likely to remain in repair mode in 2012. We are looking ahead to a small upturn in 2013. For clients with the wherewithal to invest in **commercial real estate**, 2012 may offer additional opportunities to acquire quality assets at distressed prices both domestically and abroad. That said, we remain underweight real estate as an asset class, given our preference for other assets.

U.S. TRUST
Bank of America Private Wealth Management

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OTHER IMPORTANT INFORMATION

Past performance is no guarantee of future results.

All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Investing in fixed income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

Stocks of small and mid cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.

Treasury bills are less volatile than longer term fixed-income securities and are guaranteed as to timely payment of principal and interest by the U.S. Government.

Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

Diversification does not ensure a profit or guarantee against loss.

Breakdown reflects ratings from Standard & Poor's, Moody's and/or Fitch Ratings. For additional information on ratings, please see www.standardandpoors.com, www.moodys.com, and/or www.fitchratings.com

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