VANDERBILT AVENUE ASSET MANAGEMENT

Fourth Quarter 2008

The fourth quarter of 2008 was significant in terms of economic and financial market news. Third quarter real GDP came in at -0.5%, unemployment ended the year at 7.2% and the November CPI was -1.7%-the steepest monthly drop since the government began tracking prices in 1947. The core inflation rate (excluding food and fuel prices) was flat in November and rose 0.4% annualized for the trailing three months. Fourth-quarter GDP is expected to decline 4% to 5%, or more, with weakness continuing into 2009. Recently released minutes from the December Federal Reserve meeting outlined an outlook of deep economic contraction through the first-half '09, slow growth in second-half '09 and rising unemployment into 2010. The official start of the recession was determined to be December 2007. The consumer (70% of GDP) borrowed less and saved more resulting in a 3.7% decline in the third quarter in real consumer spending. This is the largest drop since the 1980 credit controls were introduced and the fourth-quarter is expected to show an even a greater decline. The dismal holiday shopping season is reflective of this environment-retail sales declined 1.7% in December from a year ago. The consumer is faced with a weakening labor market, declining home and stock prices and frozen credit markets. Households paid down debt for the first time since the central bank started collecting data in 1952. This deleveraging process on the part of both consumers and the business sector will continue for some time. The consumer had been growing at about 4% over the last 14 years and will slow to the 1%-2% range for a longer-term period. Even exports, recently a relatively strong part of the economy, have experienced a slower rate of growth.

The budget deficit will grow to approximately $1.2 trillion for the fiscal year ending September 30, 2009. This is before the new fiscal stimulus program to be introduced by the Obama administration. This program could approximate $1.0 trillion over a two-year period with a combination of infrastructure spending and tax reductions. This fiscal policy along with an aggressive monetary easing policy (outlined below) is designed to mitigate the effects of a severe recession. Various numbers paint a dismal 2008 for the economy and financial markets: the S&P equity index declined 38.5%, 2.5 million jobs lost, the yield on three-month US Treasury bills was a -0.016 on December 4 (the minus sign is not a mistake), the median home price declined by 22% from July 2006 to November 2008, the price of a barrel of oil went from $145.29 on July 3 to $44.60 on December 31 and the number of banks the US government owns stock in at year-end is 206.

The fourth-quarter was an active period for the Federal Reserve. On October 8th, the Fed reduced the fed funds rate from 2% to 1.5%, a further reduction to 1% on October 29th and an additional reduction to the 0%-0.5% range on December 6. The fed funds rate was at 5.25% when the credit crisis began in August '07. The Fed said they would print as much money as needed to revive the credit markets. In addition to lowering the fed funds rate, the Fed is also increasing its balance sheet as it purchases longer-term securities in an attempt to lower longer-term rates and improve liquidity. Their press release stated "The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth." Such tools include buying large quantities of mortgage-backed securities, longer-term US Treasury securities, corporate debt and consumer loans. The Fed said "… over all, the outlook for economic activity has weakened further." Since September, the Fed's balance sheet has grown from approximately $900 billion to over $2 trillion. The Fed's problem is that although official borrowing rates have declined, rates for borrowers with even negligible risk are higher than a few months ago. While potential inflation ramifications are a consequence of aggressive monetary and fiscal policies, this is a longer-term issue not to be worried about over the next two quarters.

Corporate Bond Market Review

2008 will go down as the worse year for US credit markets as performance deteriorated dramatically during the fourth quarter. A crisis that started with falling home and subprime mortgage prices cascaded into systemic unwinding of leverage and risk assets. These events had significant consequences (many unintended) as volatility increased and liquidity evaporated for all assets other than US Treasuries. For the corporate sector, spreads widened so significantly that excess returns (returns versus similar duration US Treasury issues) reached negative 20% during November. Investors might be surprised to realize that yields on corporate bonds ended 2008 only 120 basis points higher than where they started 2008. This seeming incongruity stems from two factors: intermediate Treasury yields fell 180 basis points during 2008 while the Lehman Credit Index spread widened 312 basis points.

Despite the gloom there were some trends and market movements towards the end of 2008 that should give credit investors some optimism heading into 2009. First, as the new issue market slowly opened in the fourth quarter, deals were priced at spreads significantly wider than where comparable secondary positions were priced. While this initially pressured all secondary positions, the peak in spreads was reached on December 3rd at 545 basis points. Spreads tightened 47 basis points through year-end as investors realized investments in corporate bonds were offering equity-like returns with a significant cushion versus any reasonable forecast of future defaults. Second, the Federal Reserve announced toward the end of November that it would be purchasing a significant amount of assets in an effort to reduce mortgage rates. This may have given investors the green light to slowly purchase risk assets again and high quality corporate bonds were all of the sudden touted as being the asset class of choice heading into 2009. We came into the quarter with a neutral allocation to the corporate sector. We then began to buy new issue corporates beginning in October eventually building a modest overweight. Our approach has been to focus on high quality issuers with strong balance sheets and leading industry positions. We have also been adding finance issues guaranteed by the FDIC as part of the Treasury Department's Temporary Liquidity Guarantee Program.

Mortgage-Backed Securities (MBS) Review

Mortgage-backed securities (MBS) provided excess returns versus their US Treasury benchmark of negative 187 basis points and positive 33 basis points during the quarter and the month of December respectively. The announcement on November 25, 2008 by the Federal Reserve to purchase $500 billion of agency debt contributed to the positive MBS performance in December. This is a new step that the government has taken to demonstrate its decision to keep mortgage rates low, support the housing market and help distressed homeowners. The duration of the MBS index peaked in October but the drop in duration since that time has not triggered the typical convexity concerns associated with sharply lower interest rates due to a secular decline in prepayment speeds linked to the housing slowdown. The portfolio remains overweight in high-quality, very liquid mortgages that should benefit going forward.

Asset-Backed Securities (ABS) Review

Asset-backed securities (ABS) provided negative excess returns versus their Treasury benchmark of 190 basis points and 1132 basis points over the month and quarter respectively. Although the consumer ABS sector continues to be under pressure, the Federal Reserve's creation of the Term Asset Backed Securities Loan Facility ("TALF") has helped the consumer ABS rebound from its October lows. TALF is a $200 billion program announced by the Federal Reserve to support the issuance of ABS collateralized by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration.