VANDERBILT Ave. ASSET MANAGEMENT

1st Quarter 2010

"Imagine a vast sheet of paper on which straight Lines, Triangles, Squares, Pentagons, Hexagons, and other figures, instead of remaining fixed in their places, move freely about, on or in the surface, but without the power of rising above or sinking below it, very much like shadows—only hard and with luminous edges—and you will then have a pretty correct notion of my country and countrymen. Alas, a few years ago, I should have said 'my universe': but now my mind has been opened to higher views of things."

FLATLAND, Edwin A. Abbott
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And thus begins the nineteenth century masterpiece of mathematical speculation in which a two-dimensional creature of *Flatland* breaks from traditional views of things (the "herd" in our present day and age) and seeks to explore alternative explanations of the nature of both his particular universe and those, heretofore unknown, which inhabit the same space and time.

Sounds like the fixed income marketplace to me.

Derivatives, derivatives of derivatives and all manner of acronyms for some fixed income products so complex that even many of the originators and investors in them (and regulators of them) don't know what they truly represent in terms of risk and reward. We've witnessed and continue to witness the calamities that have resulted from the obstinacy, greed and downright stupidity of same.

Among the many such calamities to date have been the destruction of several venerable Wall Street (and not so Wall Street) investment houses, the subsidization or downright takeover of several large and small banks, an erosion of trust in our entire financial and political system by individual and institutional investors who stand to lose or have lost trillions of dollars, the deepest and longest lasting economic recession in many decades…and the list goes on.

How or what to do about it? We cannot, nor would we dare, to suggest what others are doing, only what we have done and are doing to protect our clients' interests in this multidimensional environment, as follows.

Macroeconomic Review

Despite fourth-quarter '09 real GDP growth of 5.6% (versus 2.2% growth for the third quarter), we do not expect to see a rainbow on the horizon going forward; rather, we should experience a series of squalls as investors absorb, to the extent possible, massive and growing government debt, the pressing need to restructure consumer balance sheets and continuing softness in labor markets, amongst other factors.

The Federal budget deficit at $1.6 trillion represents a relatively large 11% of GDP and the forecast is for large deficits looking out over the next 10 years. Inevitably and painfully, these deficits can only be moderated…if not, in fact, reduced… through a combination of spending reductions and tax increases, both of which are unpalatable to powerful special interests and consumers/corporations, at large. As fiscal stimulus begins to wane and the Fed inches toward exit strategies, the question is whether the consumer and business sectors will revive demand and sustain economic growth. We are not optimistic on this score.

At their March meeting the Federal Reserve kept the benchmark fed funds rate unchanged for an "extended period" and affirmed their plans to stop purchasing mortgage-backed securities (they have purchased $1.25

trillion). Again, inevitably, the Fed will have to increase the federal funds rate. In no small manner, we are at a crossroad with regard to how much and when. This is relatively new territory, and the old rules may not apply.

During the first-quarter, the shape of the yield curve became slightly more positive. Two and five-year US Treasuries declined approximately 13 basis points, the 10-year was unchanged and the 30-year increased 7 basis points. The yield curves are as follows:

	31-Dec	31-Mar	Change
3-monthTreasury Bills	0.05	0.15	0.10
6-month Treasury Bills	0.19	0.23	0.04
2-year Treasury Note	1.14	1.02	-0.12
5-year Treasury Note	2.68	2.54	-0.14
10-year Treasury Note	3.84	3.83	-0.01
30-year Treasury Note	4.64	4.71	0.07
10-year vs. 2-year	2.70	2.81	0.11

Mortgage-Backed Securities

Mortgage-backed securities (MBS) provided positive excess returns versus their US Treasury benchmark of 69 basis points for the quarter. As mentioned above, the Federal Reserve completed purchasing $1.25 trillion of Agency MBS. With the completion of this program, mortgage rates and spreads may come under pressure; however, it may not cause significantly higher mortgage rates as investors return to the market to replace the Federal Reserve as the buyer of MBS.

In the month of February, Fannie Mae and Freddie Mae announced that they would buyout delinquent loans from their outstanding pools causing principal to be returned to investors quicker than originally expected. This development will generate approximately $140 billion from private investors to reinvest in the MBS market. To put this in perspective, if only half of this $140 billion is reinvested in the MBS market, this represents the equivalent of having the Federal Reserve purchase mortgages for two additional months. Both the potential $140 billion reinvestment in the Agency MBS market and 12% lower Agency MBS issuance for 2010 versus last year represents a strong technical for the sector that should aid the market in the Fed's absence.

Currently, the thirty year mortgage rate is at 4.96% versus 5.09% at the end of 2009. MBS rolls continue to offer an attractive carry and yield pick-up versus comparable US Treasury issues. We continue to hold 2003-2005 vintage pools backed by Agency mortgages due to the seasoning and better underwriting standards at the time these mortgages were originated. The allocation to MBS is underweight the benchmark. MBS continues to be rich and we expect that as the Fed exits their purchase program market spread levels will widen providing an opportunity to increase the sector allocation at cheaper levels.

Corporate Securities

Investment grade corporate bonds continued their march to higher valuations that started in the second quarter of last year. Excess returns (return earned over similar maturity US Treasuries) in 1Q 2010 were 114 basis points. Absolute returns for the sector were +2.30% versus 1.12% for US Treasuries. Client portfolios benefitted from this outperformance not only with a higher allocation to corporate securities relative to their benchmarks, but also with a higher allocation to financial company issuers. Corporate securities issued by financial institutions earned an excess return of 171 basis points versus lower returns for industrial issuers (+80 basis points) and utilities (+93 basis points). Although there was a lull in issuance in February as markets reassessed risk emanating from Europe (Greece), overall issuance for the quarter ($240+ billion) was similar to that of last year- excluding the issuance of FDIC guaranteed corporate issues. Portfolios benefitted from the

new issue market, picking up attractively priced bonds particularly in the financial sector. We added high quality names such as GE Capital, Prudential and Berkshire Hathaway.

We anticipate demand to remain robust for corporate issuance in the second quarter. The additional yield pickup over US Treasuries remains fair to attractive based on historical analysis, and investment grade corporate issuers continue to improve from a fundamental perspective. Although there remains room for further excess return due to spread narrowing, much of the additional return will come from the incremental yield received relative to US Treasuries.

There are two main risks to our high allocation to the corporate sector. The first is that new financial regulatory legislation negatively impacts investors' perception of risk to the sector. And the second is issuer specific risk due to fundamentally sound and attractive balance sheets attracting a private buyer (LBO) or growth acquisitions impairing financial statements. To address each risk, we do not anticipate interest rate volatility to be high enough to disrupt credit performance. Higher rates by themselves are not harmful to credit spreads, and indeed can be helpful if arrived at in an orderly fashion. In regard to new financial regulation and reform, we believe investors are being compensated for the additional risk. Option adjusted spreads for the financial sector remain wide to industrials (+186 vs. +126), whereas prior to 2008, financial spreads traded through industrials. Lastly, we will continue to work vigorously to identify companies that may be tempted to lever up their balance sheets. In addition, we will keep portfolios very diversified so as not to be overexposed to any given issuer.

In Conclusion

Sadly, the hero of *Flatland*, having sought to explain and to demonstrate the nature of alternation realities, was imprisoned indefinitely for what were considered his seditious views.

His closing comments speak volumes of the effects of being a visionary in a static environment, one that is content to live with its ignorance of what lay around it:

> "It is part of the martyrdom which I endure for the cause of Truth that there are seasons of mental weakness, when Cubes and Spheres flit away into the background of scarce-possible existences; when the Land of Three Dimensions seems almost as visionary as the Land of One or None; nay, when even this hard wall that bars me from my freedom, these very tablets on which I am writing, and all the substantial realities of Flatland itself, appear no better than the offspring of a diseased imagination, or the baseless fabric of a dream."

Well, we are not shackled by the bonds of willful ignorance, nor are we willing to race headlong into an abyss in pursuit of alluring profits that may be based on a house of cards.

Never have we done so, and never will we.