VANDERBILT Ave.
ASSET MANAGEMENT

2nd Quarter 2011

Anyone who has played ten-pin bowling knows that the object of the game is to insert three fingers into a ball of various compositions and of various weights, move it across a certain space in a more or less coordinated motion, approach the foul line in a sliding stop, and release it.

Relieved of our burden, we watch as the ball makes its way down a somewhat broad, yet straight path. If one's aim is true, the pins drop and a strike is called. If it varies so much as an inch, the results can be virtually impossible to overcome (think 7-10 split).

Aside from these and other mechanics of the game, a peculiar mythos surrounds one inviolable rule: If you cross the fault line, you lose your turn, with no chance of gain.

Less heralded, yet well known to those of us who have crossed this line is the psychological impact of doing so. Suddenly, we are in another dimension of mind and space. In this forbidden zone on the opposite side of the line, we find ourselves utterly alone, no longer part of the game. Behind us, the party carries on. Before us, it has ceased to be, at least for the moment. We see only the stark emptiness of an endlessly repeating set of parallel lines leading where we do not know. It's a spooky place.

We then shake ourselves, retreat a step or two, and return to the familiar environment on the "right" side of the line. At once, all is well and the game resumes.

We are approaching this metaphorical fault line in the long dominant economies of the West: those of the United States and the European Union. We must soon decide whether we are going to step back into the security of the familiar, or continue into the void.

More on this, later.

Macroeconomic Review

First-quarter real GDP was 1.9% with a second-quarter estimate of approximately 2%. Growth came from the private sector versus the public sector. Inventory buildup was large-final sales (excludes inventories) rose only 0.7%. Consumer spending (70% of GDP) was up 2.7% vs. 4% the previous quarter. Exports grew at a slower pace from previous quarters as emerging market growth slowed. Core CPI was 1.5% versus a year ago and remained below the Fed's overall long range objective of 2%; however, the pace of inflation has quickened. We are lowering our second-half 2011 GDP estimate to 2% due to (1) Federal Reserve credit is up while bank credit has declined; unless bank credit increases, the mid-year termination of QE2 implies deceleration in growth of monetary financial institutions' credit with a negative impact upon nominal GDP, (2) potential adverse effect upon exports emanating from monetary policy tightening actions in key emerging markets and (3) continued headwind from housing (and numerous ancillary industries) due to foreclosure loans in the pipeline and borrowers with negative equity that are not delinquent. A continued soft labor market (weak wage gains and 9.2% unemployment) and a consumer still deleveraging are also headwinds to a more normalized recovery. In addition, the government sector is in the process of implementing a more austere fiscal policy. Economic recovery is dependent upon growth in commercial bank lending, a stronger labor market and improving consumer confidence. There have been seven straight quarters of growth but the recovery is tepid vis-à-vis previous recoveries.

The current economic environment in the U.S. is being driven by components that historically have not led the U.S. economy in the past. U.S. exports are leading the economy out of recession, when in the past it was domestic demand for goods and services that held that role. But domestic demand has been impaired by a consumer sector that is over-leveraged and a banking sector, weakened by the financial crisis, that has tightened lending standards.

In developing economies, financial companies have not been impacted to the same extent by the crisis because they avoided or had limited exposure to the type of structured financial products that affected institutions in developed economies. In addition, emerging economies did not experience the “bubble effect” in their housing markets while the middle class continues to grow and increase its demands for goods. The underlying strength in consumer demand with a healthy financial sector has caused emerging economies to attain a 25% weighting of the contributors to real Global GDP. This contribution has caused an increase in the speed and scale of the global business cycle.

The effect of the emerging world’s economic performance has caused a shift in leadership as the global economy emerges from recession. Developing economies started the recovery several months sooner than would have been the case. Consumer demand from overseas has placed exports at the leading edge during the recovery here in the U.S. Traditionally, domestic consumption and housing led the U.S. economy back to recovery.

To illustrate, during the first eighteen-months of the U.S. economic recovery, exports and investment contributed 2.8% to the growth in real GDP. That is one full percent above the historical average and their contribution has outperformed consumption and housing for the first time since records have been kept. Consumption and housing have added only 1.5% to real GDP, down from an historical average of 3.6%.

Interest rates declined during the second-quarter and the yield curve was modestly steeper as the shorter end of the curve declined more than the longer end. The following outlines U.S. Treasury levels for the second-quarter:

	31-Mar	30-Jun	Change
3-monthTreasury Bills	0.09	0.01	-0.08
6-month Treasury Bills	0.17	0.10	-0.07
2-year Treasury Note	0.82	0.46	-0.36
5-year Treasury Note	2.28	1.76	-0.52
10-year Treasury Note	3.47	3.16	-0.31
30-year Treasury Note	4.51	4.37	-0.14
10-year vs. 2-year	2.65	2.70	0.05

Corporate Securities

The corporate sector provided negative excess returns versus similar maturity US Treasuries. Underperformance was led by financial institutions followed by industrials and then utilities. We remain overweight this sector. This is due to a number of factors.

Corporations remain in the best financial shape that we have seen in over a decade. Corporate balance sheets are characterized by higher cash balances, improved earnings and cash flows, and reduced leverage. Upside earnings surprises (i.e. where actual reported earnings have either met or exceeded average analyst estimates) have been coming in at roughly 79%. Global economic growth will continue to contribute to further corporate earnings improvement.

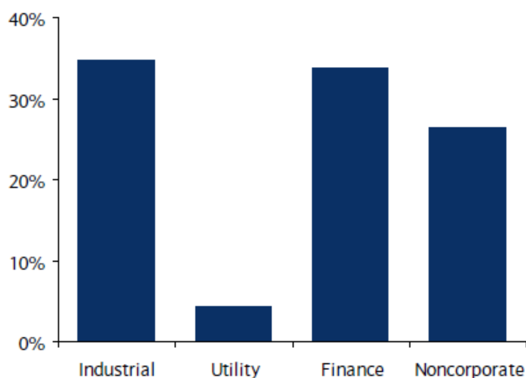
Bank financial strength continues to improve. Tier 1 common ratios for U.S. banks remain above 9% (vs. a low of 4%-5% for Q1 2009), and are expected to rise further given the current strict regulatory environment. Industrial

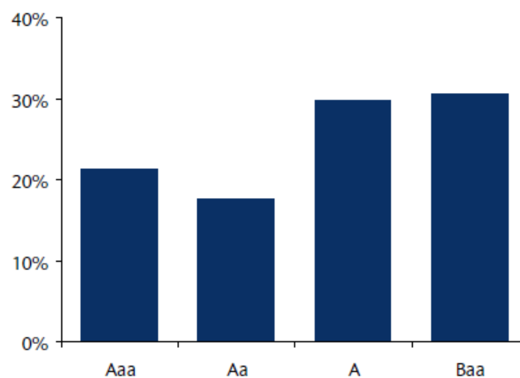
leverage remains low (Debt/EBITDA is approximately 1.7x & Interest coverage 17x), as EBITDA increased vs. stable debt levels.

U.S. corporate issuance continued at a brisk pace in Q2, totaling approximately $200 billion ($494 billion YTD), as companies continued to capitalize on low interest rates and strong investor demand. We believe that issuance will remain healthy through the remainder of 2011, as corporations look to refinance and extend maturities.

Investment Grade Corporate Fixed Supply

	2011										
	1-5 yr	6-12 yr	13yr+	Total	%		1-5 yr	6-12 yr	13yr+	Total	%
By Sector						By Quality					
Industrial	66,975	76,778	28,225	171,978	35%	Aaa	98,985	4,950	2,550	106,485	22%
Utility	4,785	10,520	7,532	22,837	5%	Aa	48,775	34,600	4,100	87,475	18%
Finance	99,233	62,413	6,700	168,346	34%	A	76,737	56,753	14,732	148,222	30%
Noncorporate	102,385	23,950	4,750	131,085	27%	Baa	48,881	77,358	25,825	152,065	31%
Total	273,378	173,661	47,207	494,246		Total	273,378	173,661	47,207	494,246	
	55%	35%	10%				55%	35%	10%		
Govt. Gtd.	0	0	0	0		Govt. Gtd.	0	0	0	0	





Investment grade corporate yields widened by 11 basis points during the first-quarter, averaging 153 basis points over US Treasuries. The biggest contributor to this increase was financials, with a +23 basis point increase. Despite this backup in credit spreads, we still believe that this sector provides the biggest opportunity, as historical spreads have averaged closer to +120 basis points (i.e. the impact of a 33 basis point tightening on a 5-year bond position would represent an approximate +1.5% price return over and beyond coupon income). Spread volatility will continue, due to such factors as significant M&A activity, continued southern European sovereign debt concerns, as well as geopolitical events in Africa and the Middle East. However, we do believe that the longer-term trend remains positive and will continue to seek out the most attractive relative value opportunities within the corporate sector.

Mortgage-Backed Securities

Mortgage-backed securities performed solidly during the second quarter of 2011. The mortgage-backed security ("MBS") sector returned 2.28% during the quarter. The MBS sector had positive excess returns of 35 basis points versus similar maturity US Treasuries for the quarter.

Our holdings throughout the quarter consisted mainly of Ginnie Mae and Freddie Mac. This was due to the better relative value of Ginnie Mae's and Freddie Mac's versus the comparable Fannie Mae's. Ginnie Mae's and Freddie Mac's have outperformed Fannie Mae's with total returns of 2.88% and 2.20% respectively. The option-adjusted

spread ("OAS") for fixed rate MBS was basically unchanged during the second-quarter. Throughout the quarter, OAS traded in a range between the tight of 32 basis points on April 11th and the wide of 55 basis points on June 16th.

We began the second quarter with a position composed predominantly of Ginnie Mae 30-year 5% and Freddie Mac 30-year 4.5%. In April we saw better value in Freddie Mac's and swapped our Ginnie Mae position for Freddie Mac's. During the month of May, Ginnie Mae's widened over 20 basis points. We deemed these new levels to be an attractive point to revisit our Ginnie Mae position. The MBS sector as a whole has been trading in a range of 37 to 54 OAS during the second quarter of 2011 and it is relatively fair valued at these levels. In the current stable rate environment, extension risk should be less of a concern. Overall volatility should be low in the next few months and we will continue to seek relative value within the agency coupon stack.

In Conclusion
In the United States, the most obvious, if not the only line we are approaching is the choice of whether to increase our nation's debt ceiling, or default, at least cosmetically, on our obligations. In the European Union, it is whether to continue continental economic support of certain failing member nations.

Of easy answers, there are none.

The outcome of this game is undetermined. Although some might argue otherwise, we have not yet crossed these lines. But we are close.

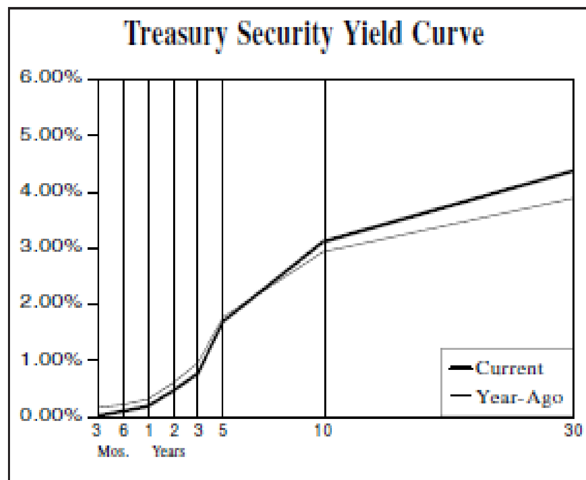
I, for one, lack the hubris to state with any conviction what will happen when these lines fall behind us.

But, consider. In bowling, the player who makes a foul and takes the hit is, in a sense, released from the past. He knows his penalty is absolute, with no appeal. Yet he also knows, with equal certainty that the rest of the game remains in play. He knows more or less exactly, what he has to do to, how perfect his game must be, to salvage a win. Doing so will require discipline, honesty, coordination...and a favorable nod from good dame Fate.

The question for our respective leaders now is whether we will take the uncomfortable steps needed to return to the familiar, or continue into the void. The game is in the balance.

The clock ticks, without pause.

	Recent (6/29/11)	3 Months Ago (3/30/11)	Year Ago (6/30/10)		Recent (6/29/11)	3 Months Ago (3/30/11)	Year Ago (6/30/10)
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	0.75	0.75	0.75	GNMA 5.5%	2.02	2.68	1.84
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25	FHLMC 5.5% (Gold)	2.63	3.28	1.59
Prime Rate	3.25	3.25	3.25	FHLMC 5.5%	2.50	3.17	1.54
30-day CP (A1/P1)	0.17	0.22	0.36	FHLMC ARM	2.51	2.63	2.94
3-month Libor	0.25	0.30	0.53	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	4.58	4.70	4.51
6-month	0.26	0.29	0.40	Industrial (25/30-year) A	5.47	5.50	5.07
1-year	0.44	0.47	0.70	Utility (25/30-year) A	5.42	5.46	5.20
5-year	1.64	1.71	2.02	Utility (25/30-year) Baa/BBB	5.92	6.06	5.73
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.02	0.09	0.17	Canada	3.09	3.29	3.08
6-month	0.10	0.17	0.22	Germany	2.98	3.34	2.58
1-year	0.19	0.26	0.31	Japan	1.13	1.25	1.09
5-year	1.69	2.20	1.77	United Kingdom	3.33	3.67	3.36
10-year	3.11	3.44	2.93	**Preferred Stocks**			
10-year (inflation-protected)	0.67	0.98	1.08	Utility A	5.13	5.70	6.08
30-year	4.38	4.50	3.89	Financial A	6.02	6.02	6.57
30-year Zero	4.76	4.79	4.10	Financial Adjustable A	5.48	5.48	5.48



Source: Value Line, Inc.