VANDERBILT Ave. ASSET MANAGEMENT

2nd Quarter 2012

At times like these…and frankly, it is difficult to recall any times quite like these…it is tempting to stretch the limits of hyperbole. "Massive, virtually unprecedented economic implosions." "Avalanches of angst." "Eruptions of this and that." And so on…and on. And, yet again, on.

So, in this review of the market environment during the second quarter of 2012, along with that going forward, we will save on the exclamation.

There is a sunny side to this story…sort of…but for now let's peel off the cover of the global economy as it stood at the end the quarter and look at some of the darker elements which lurked within.

Even with our focus on domestic debt, it is impossible to segregate this asset class from the monumental happenings in Europe…

…beginning with Greece. Greece: a pejorative of our new economic age, yet no disrespect at all intended; rather, sympathy for this country's plight. Who would have thought as this quarter ended that we would look back with a perverse sort of nostalgia for the "good old days", when Greece was all we had to worry about.

No one in charge of their wits thinks so now, if, in fact, they ever did. Certainly, the question of Europe's survival as a workable fiscal entity is far from settled, but for Greece, it may well be. Suggesting this were parliamentary elections in June, at which time voters weighed in on the economic realities their country faces, yet barely agreed to abide by previously negotiated agreements to keep its fiscal ship afloat. Far from being resolved, this lack of unanimity on even basic reforms suggests it is unlikely that Greece's maiden voyage into modern financial and regulatory discipline will arrive at a harmonious port of call.

As events progressed throughout the quarter, the often-whispered, "never-possible" collapse of Spain's financial system devolved into boisterous calls for recapitalization and bailouts from Union members at large, calls that met with some resistance amongst some of the better-heeled European Unionists…

…and led to renewed worries about Italy's financial integrity.

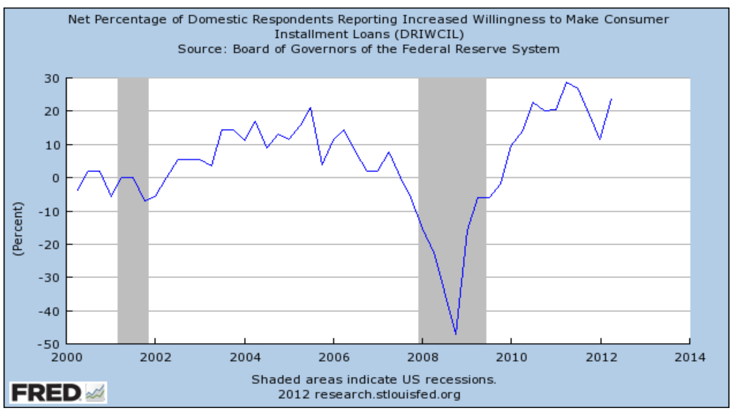
Elsewhere, in April, France elected a socialist president whose proposed, if not strenuously implemented agenda (at least so far), appears counter to what Germany wants to see. Then, there was well winked "public speculation" about "governmental plans" to shield the United Kingdom's currency from the effects of a "possible continental financial collapse" (quotations added to this non-story story, one of many knee jerk and harmful bleats during this period). Even tiny Cyprus chimed in with a near desperate plea for assistance. We do not have space here to revisit similar issues that have enveloped Ireland, Portugal and several others.

And then there was Germany, which we will get to following a review of this quarter's actions on your behalf.

Macroeconomic Review

Real GDP grew 1.9% in the first-quarter versus 3.0% the previous quarter. Consumer spending (approximately 70% of GDP) provided the growth while business investment cooled. State and local government spending declined 2.5%. Consumer spending rose 2.7% versus 2.1% the previous quarter. Inventories were leaner which should be a stimulus for future quarters. Residential investment is stabilizing. Growth in residential housing was 19% which was the fourth consecutive increase in this sector. This is the first time housing has shown a straight year (four consecutive quarters) of growth since 2005. The labor market remains weak. Unemployment is 8.2% and the pace of jobs growth is slow. However, as a possible precursor to a somewhat more buoyant labor market, recent new claims for jobless benefits dropped to the lowest level in four years. First-quarter final sales (excludes inventories) were 1.8% which represented an increase from 1.1% the previous quarter.

We continue to look for growth greater than the consensus and are monitoring bank credit in particular. Swings in interest rates have traditionally had a dramatic impact on domestic savings, spending and investment behavior. However, the 2008-2009 Great Recession and global financial crisis left the monetary transmission mechanism impaired, materially reducing the flow of liquidity to the economy. In response, policymakers have been forced to become much more aggressive and use unorthodox measures to prevent a liquidity trap. Monetary policy begins with the authorities altering the monetary base. The monetary base has two components: reserves held at the central bank and currency held in circulation. These have a very different influence on growth and inflation. An increase in reserves is the traditional mechanism for monetary policy. In contrast, an increase in money in circulation has a minimal influence on economic growth but a material impact on inflation. Policymakers have expanded the monetary base by flooding the banking system with reserves. These reserves have yet to turn into strong lending activity by the banks; however, there are indications that loan growth is beginning to pick up (see chart below).



At their recent meeting the Federal Reserve extended Operation Twist (selling shorter dated Treasury securities and purchasing longer dated ones) through year-end and vowed to take more stimulus actions if the economy warranted it. Does the election matter for Fed policy making? Of course. Federal Reserve officials will do what is necessary and appropriate, but their deliberations will include, in part, the context within which the public views any action taken in an election year. If employment were to decrease or if European markets deteriorated dangerously, the Fed would scale up its balance sheet program or ensue on a new course of action to meet the challenge. The Fed's credibility in either case would not suffer because its actions would be the object of headlines and not the subject.

Much riskier for the Fed is to make a tactical adjustment in policy after the accumulation of modest disappointments to the economic outlook or reassessment of future risks. In this case, the motivation behind such a move would not be self evident. This would invite additional scrutiny to Fed policy and cause some to make the charge of partisanship in Fed decision making during what will surely be a rancorous campaign season. A headline such as "Fed Launches October Surprise" would not just be an irritation to the Fed, it would be an invitation to political backlash.

If the world produces drama before November, the Fed would act dramatically. The Fed, however, will not initiate market drama.

For the quarter, interest rates declined with greater declines in the longer end of the yield curve resulting in a flatter curve. Interest rate changes were as follows:

	30-Mar	30-Jun	Change
3-monthTreasury Bills	0.07	0.08	0.01
6-month Treasury Bills	0.13	0.15	0.02
2-year Treasury Note	0.33	0.30	-0.03
5-year Treasury Note	1.04	0.72	-0.32
10-year Treasury Note	2.21	1.65	-0.56
30-year Treasury Note	3.34	2.75	-0.59
10-year vs. 2-year	1.88	1.34	-0.54

Corporate Securities

After a strong first-quarter of the year, corporate bond performance was mixed during the past quarter. For instance, shorter corporate bonds provided 0.36% total return during the period versus a return for comparable U.S. Treasuries of 0.19% as measured by the Merrill Lynch Index. The overall corporate bond market did not perform as well. The Investment Grade Corporate Bond Index, which includes all maturities, underperformed comparable U.S. Treasuries by 1.27%. After a stellar first-quarter, banks and brokerage companies shrugged off several negative news items pertaining specifically to money center banks to provide better performance than the overall corporate market. Communication, mining and energy companies had the weakest performance during the quarter with latter two reflecting a growing market concern over a slowdown in worldwide economic growth.

Your portfolio's overweight position is based on attractive valuation and ongoing strong financial fundamentals of U.S. corporations. During the first quarter, approximately 70% of companies reported positive or in line earnings that resulted in key credit metrics remaining in an enviable position. Gross leverage is at just 2.0 times EBITDA, EBITDA/Interest Expense coverage is over 10 times and the cash to debt ratio remains above 20%. Our quantitative screen, which utilizes equity prices, volatility and debt levels, confirms that credit spreads remain attractive. Second-quarter results will be watched closely for evidence, through our bottom up security selection process, that recent economic headwinds are not having a meaningful impact on the financial fundamentals of U.S. corporations. Several companies on our buy list include AT&T with 11.5 times EBITDA/Interest Coverage and just over 2.2 Gross Leverage. Their bonds provide over 60 basis points of excess spread over their credit risk. St. Jude Medical, a healthcare medical device manufacturer, has strong cash flow at 25 times Interest Expense and Gross Leverage of 1.7 times. Within the Utility sector, Duke Energy Corp. has reasonable valuation at 23 basis points of excess spread and stable cash flow coverage of 6.4 times. Each of these companies had a positive earnings surprise in the first quarter.

Financial companies were able to shrug off several negative events during the last three months, including downgrades of most money center banks by Moody's, JPMorgan's trading losses and issues over setting of Libor to end the quarter as one of the better performing sectors in the corporate market, though still underperforming U.S. Treasuries. Improving asset quality and stronger capital support make current valuations attractive but must be balanced against regulatory, legacy risks and elevated volatility. First-quarter results for the top 25 U.S. banks show net charge-offs dropped by over 8% and the Tier 1 common ratio rose by 0.30% to 10.8%. The sector has room for further improvement if net interest margins improve from current depressed levels of just 2.97%, the second lowest quarterly result for the period beginning in the fourth-quarter of 2008. Second-quarter results will dictate our positioning in the sector moving forward. Second-quarter results have started with JPMorgan announcing a significantly positive earnings surprise. Their well publicized $4.4 billion trading loss was partially offset by other trading gains, reduction in loan-loss reserves and positive impact of the debt valuation adjustment. Their Tier 1 common equity remained stable.

Mortgage-Backed Securities

Mortgage-Backed Securities (MBS) slightly underperformed comparable U.S. Treasuries during the second-quarter. Your portfolio includes both FNMA & FHLMC securities with average coupons of 4.5% to 5% and short weighted average lives. Using our rigorous selection process, we invest in those securities which exhibit favorable option adjusted spreads and stable prepayments.

During the second-quarter, we increased overall exposure to MBS to capitalize on their attractive yields and the new Fed program. In June, we shifted a significant portion of our position from FNMA to FHLMC securities, due to the positive yield differential currently afforded by them. The Federal Reserve remains committed to maintaining stable short-term interest rates in the near-term. MBS should continue to benefit from this stable rate/low-volatility environment, as the value of the embedded prepayment option in the underlying mortgages is reduced.

We believe that continued strong demand for these highly-rated, liquid MBS, coupled with limited supply, should benefit this sector's performance in the third-quarter.

In Conclusion

On the other side of the ledger, Germany vocally opposed becoming the *de facto* lender of last resort for the "other countries" in the European Union, a role that others would have it assume, largely without meaningful concessions, and perhaps to its detriment. There was even talk of its return to the Deutschemark and abandonment of the Euro, if not necessarily the European Union per se.

But such speculation was just talk, and "just talk" fairly characterizes existing attempts to find some way out of this huge mess. To be sure, there were daily op-eds proposing one rescue plan or another, but most of these centered on buying time, rather than on making the very hard decisions most believe to be inevitable. This lack of serious discussion, much less action, unsettled investors, who flocked to the equities of "safe" sectors, in the process driving their prices well beyond reason.

This lack of investor confidence in political solutions or near-term resolutions permeated global markets, from China's formerly unstoppable but now sputtering economic engine, to those of India and Brazil, thus lessening through association other emerging markets.

In all, the global economy, as represented through most of the world in the second quarter and much of the fairly recent past, objectifies that old and too familiar Chinese curse: May you live in interesting times.

We certainly do. Yet, through all of this and more, think of this. When the world seeks economic stability and promise, where do they turn? The U.S. When push comes to shove and investors look for the safest haven for their capital, where will they find it? No doubt, the U.S. When the rest of the world is hurting and needs assistance to resolve their respective dilemmas, where will they turn for help? You guessed it.

We are bullish on the prospects for the U.S. economy going forward, even in the face of consensus opinions that sometimes and wrongly suggest otherwise. In these volatile times, we will prosper. And from our headquarters in New York City, the fulcrum of global finance, we will continue to maintain an investment discipline that charts a steady course in pursuit of highly desirable, high quality, domestic fixed income investments and their accompanying returns. Over the long haul, you know that our process will allow us to satisfy our obligations to our clients and thereby allow them to satisfy their financial obligations to those they represent.