VANDERBILT Ave. ASSET MANAGEMENT

3rd Quarter 2011

While certainly it is easy in letters such as this to take the tried, if not necessarily true, path of simply replaying major economic indicators of the quarter just past, we think this a disservice to our readers. After all, any investor with access to a computer, newspaper, et al, already knows what transpired.

Rather, we favor the use of stories and metaphors that distill our collective impressions and present them in occasionally interesting ways.

To wit: a street in a Mexican village.

A friend of mine once told me of a visit he made to a village on the northern end of the Yucatan peninsula. He described it like this:

"As we came to the village, we saw the most bizarre roadway imaginable. The road was dirt, as many there are, but, to say it was unusually shaped? Well, imagine a perfect cone, sliced in two from top to bottom. Take these halves and align them, slightly offset, point to point. Add several more halves in a parallel series that extends through the village, until the regular, more or less level highway begins again. It was just that way. Weird, but true."

More on this after we relate what we did and why during the third quarter of 2011 to support your interests.

Macroeconomic Review

Second-quarter GDP came in lower than originally estimated at 1.3%. This represented the weakest growth since fourth-quarter 2009. The economy continues to be burdened by debt laden consumers, faced with a weak labor market, and a deleveraging process that could take a long-time to play out thereby negatively impacting spending. Business confidence is weak leading to cash hoarding by companies rather than investing. In addition, housing is a crucial piece of the ailing economy that has negatively impacted consumer spending.

The Federal Reserve, at their August meeting, promised to hold short-term interest rates near zero through at least mid-2013 and then at their September meeting, the Fed decided to recast their $2.65 trillion portfolio in an effort to reduce long-term interest rates. They will hold more long-term US Treasury and mortgage-backed securities (MBS). They hope that lower long rates will boost investment and spending and provide a stimulus to the housing sector. However, Fed policy has not resulted in increased bank credit or lending. Banks are concerned about future capital requirements and are reluctant to lend. The traditional monetary policy transmission mechanism via the commercial banking system is temporarily impaired because of banks' unwillingness to create credit in a normal manner.

Investor concern regarding the deteriorating global growth backdrop has led to a stampede into U.S., U.K. and German government bonds at the expense of risk assets (including equities and corporate bonds). Government debt markets have also benefited from aggressive support from the major central banks and another round of unorthodox policy. In particular, the Fed's conditional commitment to remain on hold until mid-2013 (if needed) and the introduction of "Operation Twist," helped drive down the long-end of the curve. Most other central banks have either eased or backed away from their tightening campaigns in response to weakness in the global economy. The bond market is now priced for at least a mild recession. The flight to safety and central bank reassurance that interest rates will remain anchored have caused government bonds to become extremely overbought and overvalued relative to their longer-term fundamentals. Likewise, the selloff in spread product (particularly investment-grade corporate debt) seems overdone.

Nonetheless, a gradual backup in government bond yields and narrowing in corporate market spreads will require some sort of resolution on the European sovereign debt crisis. Until then, risks to the global financial system and economy will escalate. European politicians do not necessarily need to bailout the weakest euro area members, but they do need to support their banking systems and stop the contagion from spreading further. German Chancellor Angela Merkel acknowledged this, suggesting that the situation is “serious,” “there are no easy solutions” and regional policymakers must erect a “barrier” around Greece. Still, European politicians desperately need to step up the pace.

The rally into government bonds is overdone but a reversal will await a solution to the European debt crisis. Even then, the backup in yields will be gradual as policy will lag. Thus, we remain defensive duration but recommend an underweight allocation to government bonds and an overweight allocation in corporate debt.

The government bond rally has led to a significant bull flattening in recent months. While yield curves remain steep from an historical perspective, there is limited room to flatten further until monetary policy starts to renormalize (which will not be anytime soon).

- The collapse in yields has left the intermediate and the long end of the curve overbought and overvalued, making it dangerous to position for a further rally. Yields will only decline from here if the global economy falls into a recession.

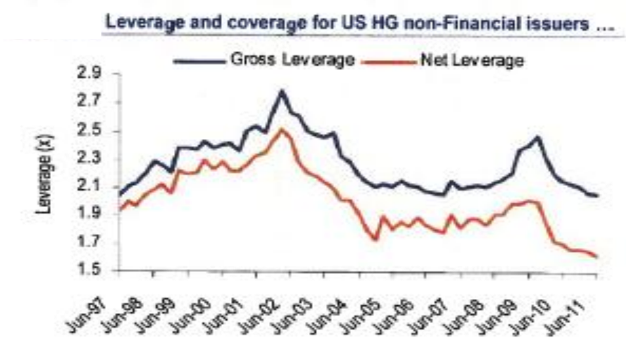
- At the same time, the short end of the curve will remain anchored for the foreseeable future. Global monetary authorities are on an extended hiatus and will intentionally lag any improvement in global growth conditions.

	30-Jun	30-Sep	Change
3-monthTreasury Bills	0.01	0.02	0.01
6-month Treasury Bills	0.10	0.05	-0.05
2-year Treasury Note	0.46	0.24	-0.22
5-year Treasury Note	1.76	0.95	-0.81
10-year Treasury Note	3.16	1.92	-1.24
30-year Treasury Note	4.37	2.91	-1.46
10-year vs. 2-year	2.70	1.68	-1.02

Corporate Securities

Our corporate bond investment is a function of a rigorous and disciplined selection process. It is a bottom-up approach in which securities must pass three screens at the time of their purchase. The three screens are strong cash flow, low short-term debt as compared to long-term debt, and a positive earnings surprise. Ultimately, it is the ability of companies to generate strong cash flow that will determine their bond success not earnings. Therefore, we look for those firms that have a history of generating excess cash flow as compared to earnings and outstanding debt. In addition, those companies that have a relatively small amount of short-term debt as compared to their total capitalization are less exposed to the vagaries of the marketplace in which their interest expenses rise if market interest rates move higher. Our Earnings Surprise screen highlights those companies whose debt is likely to outperform over the coming quarters. Throughout the third-quarter these screens identified a large number of financially strong investment opportunities within the corporate sector.

Industrial companies have dramatically improved their cash flow, leverage and short-term investment holdings over the past several years. For instance, industrial companies in the S&P 500 stock index generated $158 billion of operating cash flow after capital expenditures in the second-quarter of 2011 an increase of over 60% from the low in the first-quarter of 2009. Similar strong cash flow generation of the entire universe of high grade industrial issuers now have gross leverage coverage (Gross Debt/EBITDA) of 2.05x which is near the lows of June 1997. The strong cash flow has resulted in nonfinancial companies now having over $2 trillion in cash and other short-term investments as compared to just under $1.4 trillion in 2008 (data from the Federal Reserve). Adjusting for this cash, net leverage (Gross Debt-Cash & Equivalents / EBITDA) has reached a new low of 1.6 times for the period from June 1997.



Source: BofA Merrill Lynch Global Research

Our Earnings Surprise screen remains strongly positive for the corporate bond market. Based on these financial fundamentals corporate bonds provide long-term investment value for your portfolio. Utility earnings surprises are less predictive of future credit profile than for industrial and financial companies. Utilities are sensitive to the impact of weather, which analysts have difficulty in accurately predicting the impact from quarter to quarter.

	Positive	Negative	% Positive
Basic Materials	20	10	67%
Communications/Technology	66	16	80%
Consumer Cyclical	31	9	78%
Consumer Non-Cyclical	110	19	85%
Energy	29	13	69%
Financial	63	17	79%
Industrial	48	12	80%
Utility	17	16	52%
Total	384	112	77%

In fact, even the much maligned financial industry has dramatically improved their fundamentals over the past several years. Tier 1 capital ratio has increased to 10.0% while loan quality has improved. Net charge-offs to average loans have declined to 2.0% from 3.2% from the second quarter of 2009 and non-performing assets, as a percentage of equity plus reserves, has fallen to 10.6% from 23.3% during the same period. As with industrial bonds, financial securities are at compelling values versus alternative fixed income investments.

	2009 2nd Qtr	2011 2nd Qtr
Net Charge-Offs% Avg. Loans	3.19%	2.02%
Loan Loss Reserve % Non Performing Assets	102%	127%
Non Performing Assets % Equity + Reserves	23.27%	10.58%

The increase in your portfolio's exposure to corporate bonds was early. The sector underperformed comparable U.S. Treasury bonds during the third-quarter and adversely impacted your portfolio's overall performance during the quarter. We will remain true to our corporate investment process. Since financial fundamentals remain strong, your portfolio will maintain an overweight to the sector. This sector may underperform over the next several months but should provide strong performance for your portfolio as its intrinsic value is realized.

Mortgage-Backed Securities
With respect to mortgages, our current investment strategy focuses on U.S. Agency pass-through securities that provide attractive yield, relatively stable cash flow and liquidity. The portfolio may include GNMA 4% and 5%, as well as other pass-throughs and structured mortgage product with favorable yields and short weighted average lives. In addition, opportunities in both credit card and auto loan asset-backed securities are likely to be added to

your portfolio. These securities will be a combination of fixed coupon and floating rate bonds. They will be at the senior tranche of the structure, rated "AAA," have a duration of less than three years and consist of liquid issuers.

In Conclusion

Now, to be simplistic, this being a simple metaphor and all, consider the aforementioned village roadway as an intellectual construct of the U.S., European and, to a lesser extent, global economies. We, our respective societies, are the drivers faced with the dilemma of how to traverse this peculiar path. If we stay to the right or left, we go up and down in a kind of slanted sine wave, with gravity constantly pulling us toward the center.

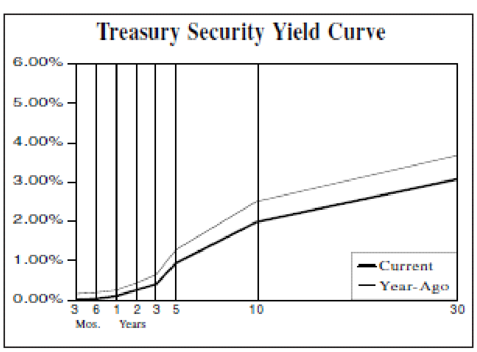
Reasonably, we should follow this center path, where we will be rattled a little, yet the shocks will be minimal and we will get to where we're going quicker. Yet, we stick to the sides, where the precipitous ups and downs take us much longer and leave us not a little nauseous. Why? Special interests, of course, in their many forms and flavors. Like perverse inertia, they resist the pull to the center, encouraging us to remain on a longer, much less comfortable path, even in the face of a still uncomfortable, yet shorter and more reasonable alternative.

Parallels exist within the fixed income world. Some, in the pursuit of elusive gains, have chosen to take the right or left. A few have succeeded. But at what price?

For our part, we believe very strongly in the long-term benefits that result from strict adherence to a systematic, highly disciplined investment methodology, one that has been time-tested over many market cycles, good and bad. While we might…might…have captured a few stray basis points by deviating from this discipline, we did not and we will not. It's as simple as that.

	Recent (9/28/11)	*3 Months Ago (6/29/11)*	*Year Ago (9/29/10)*
TAXABLE			
Market Rates			
Discount Rate	0.75	0.75	0.75
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25
Prime Rate	3.25	3.25	3.25
30-day CP (A1/P1)	0.42	0.07	0.22
3-month Libor	0.37	0.25	0.29
Bank CD's			
6-month	0.17	0.26	0.33
1-year	0.21	0.44	0.57
5-year	1.26	1.64	1.68
U.S. Treasury Securities			
3-month	0.01	0.02	0.16
6-month	0.03	0.10	0.19
1-year	0.10	0.19	0.25
5-year	0.94	1.69	1.28
10-year	1.98	3.11	2.50
10-year (inflation-protected)	0.11	0.67	0.69
30-year	3.07	4.38	3.68
30-year Zero	3.28	4.76	3.96

	Recent (9/28/11)	*3 Months Ago (6/29/11)*	*Year Ago (9/29/10)*
Mortgage-Backed Securities			
GNMA 5.5%	1.62	2.02	2.01
FHLMC 5.5% (Gold)	2.08	2.63	2.33
FHLMC 5.5%	1.97	2.50	2.14
FHLMC ARM	2.50	2.51	2.90
Corporate Bonds			
Financial (10-year) A	3.87	4.58	4.01
Industrial (25/30-year) A	4.50	5.47	4.89
Utility (25/30-year) A	4.34	5.42	4.94
Utility (25/30-year) Baa/BBB	4.98	5.92	5.46
Foreign Bonds			
Canada	2.20	3.09	2.74
Germany	2.01	2.98	2.24
Japan	1.00	1.13	0.93
United Kingdom	2.55	3.33	2.91
Preferred Stocks			
Utility A	5.24	5.13	6.08
Financial A	6.45	6.02	6.50
Financial Adjustable A	5.48	5.48	5.48
TAX-EXEMPT			
Bond Buyer Indexes			
20-Year Bond Index (Gos)	3.85	4.46	3.83
25-Bond Index (Revs)	4.96	5.31	4.58
General Obligation Bonds (Gos)			
1-year Aaa	0.24	0.24	0.34
1-year A	0.99	1.04	1.15
5-year Aaa	1.04	1.25	1.22
5-year A	2.05	2.41	2.20
10-year Aaa	2.15	2.63	2.51
10-year A	3.42	4.11	3.65
25/30-year Aaa	3.87	4.36	4.11
25/30-year A	5.53	5.86	5.40
Revenue Bonds (Revs) (25/30-Year)			
Education AA	4.56	4.87	4.61
Electric AA	4.92	5.17	4.62
Housing AA	5.55	5.79	5.49
Hospital AA	4.90	5.25	4.81
Toll Road Aaa	4.58	4.97	4.60



Source: Value Line, Inc.

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