VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2009

Any expectant neophyte who has foolishly gone to the trouble of constructing a new vegetable garden, tilling the soil, fertilizing it, planting one's desired seeds and stood back to admire his or her handiwork in the dim light of coming spring, will soon discover some things are amiss.

Surely, your plants will sprout ("surely" as in "hopefully"). As they grow, they will seem to be safe and secure, with clean little rows abounding in the promise of a bountiful harvest. Then, many unsuspected problems will arise.

The first will be wave upon wave of visitors to what you hoped to be a garden but will henceforth be known as the "Wildlife Café." Deer, a particular and destructive predator, will discover your little slice of heaven and destroy most of it. What they leave behind likely will be found by groundhogs, crows, moles and other many and various plant predators who, again, likely will decimate what remains.

If you supply and install sufficient barriers to what have become known collectively as "vermin," and regard your newly replanted source of nourishment, you will find that your tasks are not yet complete.

As the soil warms, two other forms of competitors for your affections will appear, they being bugs and weeds. Bugs of many and varied varieties will eat your newly protected sprouts. Weeds will sprout amongst those that survive and seek to absorb the nutrients that you have carefully and laboriously tilled into the soil, in the process choking off the incipient flourishing of your desired garden: henceforth to be known as "hell on earth."

You will quickly come to the opinion that this hell on earth should be abandoned to its fate and go, instead, to the grocery store for supplies of necessary nutrients for yourself and your respective families.

Fixed income markets we research and invest in are another matter, entirely. Details of how we have successfully protected, debugged and weeded your fixed income assets in the face of numerous challenges to them during this time follows, specifically in so far as the fourth-quarter of 2009 is concerned.

Macroeconomic Review

Third-quarter real GDP grew at 2.2% versus -0.7% in the previous quarter. The consumer (approximately 70% of overall GDP) provided two-thirds of this growth. Growth in the consumer sector was led by auto sales and residential construction-two sectors dependent upon temporary government stimulus programs that will be expiring. Without these stimulus programs, real GDP would have risen little if at all.

Employers remained reluctant to hire in the third-quarter. The economy is still very dependent on the government sector. The consumer will continue to be burdened with high unemployment and weak income gains, an overleveraged balance sheet and continued mediocre performance in the housing market.

Inventory rebuilding will prove to be temporary without a sustained recovery. Productivity surged at a 9.5% annual rate in the quarter as businesses continued to cut costs and were hesitant to hire. The combination of real GDP growth with productivity gains resulted in corporate profits growing at 10.6% (an annual rate of approximately 50%).

The Federal budget deficit is going to be a longer-term problem for the economy. The annual Federal deficit is estimated at $1.4 trillion. At 10% of GDP this is the largest since the funding of World War II in 1945. We forecast a weak economic recovery with the possibility of some negative growth occurring. We do not think inflation will be a concern but rather deflation is the bigger potential problem. The primary reason to fear deflation is that the Fed's balance sheet expansion from $875 billion to $2.2 trillion has not translated into additional loans by the banks. In addition, there is a large amount of excess slack in the economy in both plant facilities and the labor market.

The data released by the Labor Department showed continued weakness in the employment market during December. Any chance of a steady increase in the rate of hiring during the next several months seems unlikely given the pace of the recovery. The unemployment rate remained at 10% during December, unchanged from November's data. These rates for the unemployed should cause the FOMC to hold its course in the near term. The Federal Reserve will be seeking evidence that the economy is recovering at a strong pace before considering any changes to the current policy of monetary accommodation. When looking back at the two previous recessions where job growth was slow, 1990-1991 and 2001, the Fed did not raise rates until the unemployment rate had shown signs of coming down. During the recession of 1990-1991, unemployment peaked in June of 1992. In that example the Fed did not raise rates until February of 1994 when the data confirmed that the economy was on firm ground. During the recession of 2001, the Fed waited a full year after unemployment peaked in June 2003 before increasing rates.

During the fourth-quarter, interest rates rose across the US Treasury yield curve with the exception of the Treasury bill market. This reflects a stable Fed policy in the very short end of the market but higher rates from one-year and longer as the market began to discount the end of the recession and the potential for a changing monetary policy. Rates increased more as maturities lengthened thus resulting in a more steeply sloped yield curve:

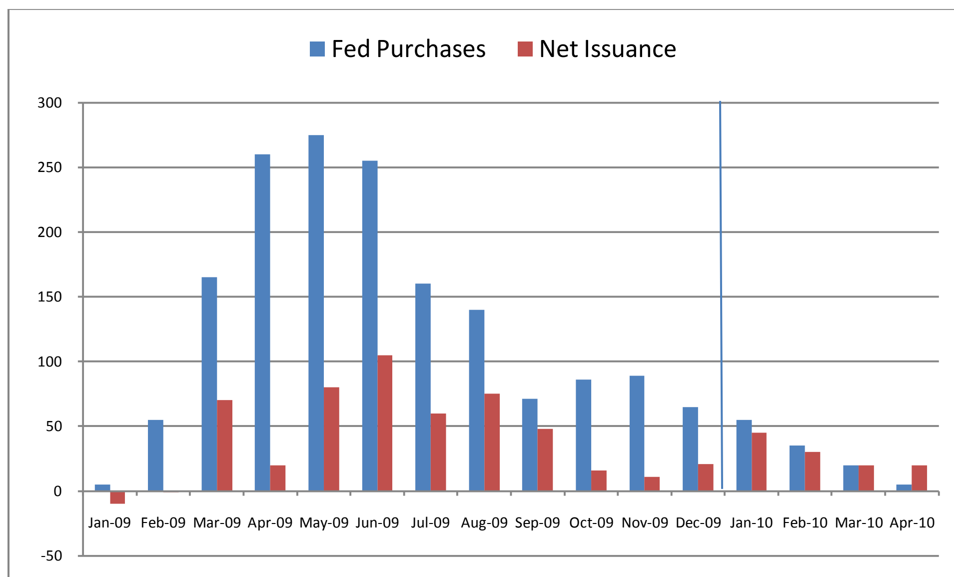
	30-Sep	31-Dec	Change
3-monthTreasury Bills	0.11	0.05	-0.06
6-month Treasury Bills	0.17	0.19	0.02
2-year Treasury Note	0.95	1.14	0.19
5-year Treasury Note	2.31	2.68	0.37
10-year Treasury Note	3.30	3.84	0.54
30-year Treasury Note	4.05	4.64	0.59
10-year vs. 2-year	2.35	2.70	0.35

Mortgage-Backed Securities

Mortgage-backed securities (MBS) provided positive excess returns versus their US Treasury benchmark of 75 basis points for the fourth-quarter. The allocation to MBS was also beneficial for the full-year 2009 as the sector had positive excess returns of 495 basis points. The Federal Reserve has purchased $1.12 trillion of Agency MBS through their $1.25 trillion program and is on pace to meet the program's targeted purchases by the expiration on March 31st 2010. These purchases have helped make homes more affordable by keeping mortgage rates low. Currently, the thirty-year mortgage rate is at 5.09%. MBS rolls continue to trade well offering an attractive carry and yield pick-up versus comparable US Treasury issues.

The Federal Reserve's purchase of MBS continues to exceed net issuance resulting in rich valuations of Agency-backed MBS (see Chart 1). As this program comes to an end, mortgage rates and spreads may come under pressure as MBS investors will likely require higher yields in order to absorb the supply absent the Agency MBS purchase program. Recently the US Treasury announced that it would not require Fannie Mae and Freddie Mac to reduce their portfolios as previously stipulated. FOMC minutes show that the Fed Governors have discussed the possibility of expanding and extending their asset purchase programs.

Chart 1



Source: JP Morgan

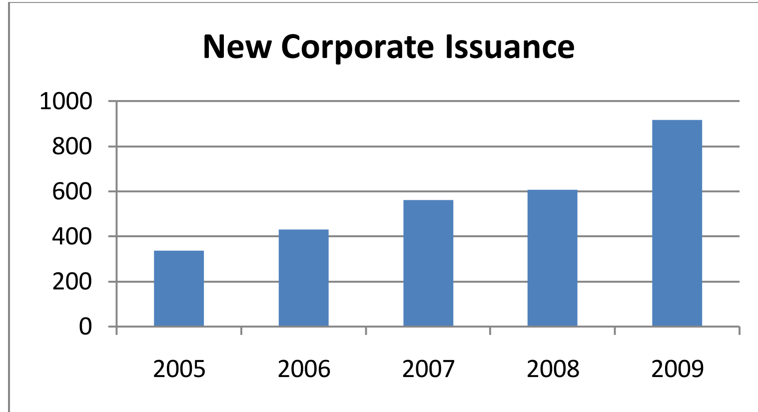
We continue to hold 2003-2005 vintage pools backed by Agency mortgages due to the seasoning and better underwriting standards at the time these mortgages were originated. We have begun to reduce our MBS exposure because mortgages have richened to the point that the government would need to expand and extend this purchase program in order to maintain these spread levels.

Corporate Securities

Investment grade corporate bond performance posted historically large excess returns versus similar duration US Treasury issues. The 267 basis point excess return was less than the 398 (third-quarter) and 1178 (second-quarter), but would still have bested all but two full year total excess return periods over the past two decades. The 1,990 basis point excess return for the year was easily the best return on record. The additional yield received for investing in corporate bonds declined from 483 basis points to start the year to 157 on 12/31/09. Investors were rewarded for taking risk in 2009. The lower rated and highest yielding securities performed best. The portfolios were able to take advantage of this dynamic with not only an overweight allocation to the investment grade corporate bond sector, but also by limiting exposure to the lesser performing securities and emphasizing the better performing ones. Genworth, held in the portfolios, was one of the top five best performing large issuers. Furthermore the portfolios avoided the worst performing issuers (Rohm and Haas, Royal Bank of Scotland and Masco), as well as having limited exposure to the worst performing sectors of sovereigns, foreign agencies and local governments. At the shorter end of the yield curve, we were amongst the earliest investors in FDIC guaranteed corporate issues. These yield spreads have narrowed significantly during the past year. For example, the Regions Bank 3.25% of 2011 was issued at a spread of 202 basis points in December 2008 and finished 2009 at a spread of 20 basis points.

The renewed confidence in the financial sector and the willingness of investors to increase risk led to record issuance in the investment grade corporate bond market (see Chart 2). We used the new issue markets to collect new issue premiums and further diversify portfolios. Although supply in 2010 is expected to moderate from its 2009 pace, we anticipate issuance to pick up again in the first-quarter. We will continue to use in an appropriate fashion the new issue market to seek value in the corporate bond market.

Chart 2



Overall we expect corporate credit quality to continue to improve in 2010. Leverage should generally decline and interest coverage should increase as cash flow improves from the low levels incurred as companies climbed out of the recession. Liquidity is high for corporate entities as they cut capital expenditures, conserve cash and extend the maturity profile of their debt with their renewed access to markets. Navigating the corporate bond market in 2010 will require a more selective and nimble posture as valuations approach more normal levels and companies begin to regain confidence in their own specific growth prospects.

Conclusion

Referring once more to the long-winded analogy that began this overview, one should keep in mind that weed seeds can remain viable for over 60 years, bugs and viruses (which we did not mention) persist almost indefinitely, and the Wildlife Café is almost always open and ready for business.

This being said, 2009 was one of Vanderbilt's best years, ever. It has been and remains our principal focus to protect, preserve and enhance the assets you have entrusted to our care.

May your fixed income garden continue to flourish in the year to come. We certainly will seek to ensure it does.