VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2011

And then there was Randall “Tex” Cobb.

Casting about for economic metaphors, analogies and unsubtle comparisons with which to encapsulate last year, the year to come and those to follow, I was reminded of Tex.

Those of you who follow boxing and have lived long enough may remember November 26, 1982, a day of infamy and courage and cussed resilience in the ancient art of fisticuffs. For on that day, Randall “Tex” Cobb fought Larry Holmes for the heavyweight title of the world.

Most people at least recognize the name of Larry Holmes, one of the (arguably) last great heavyweights to reign before no-name champions and cage fighting diminished the sport’s modestly broad audience. Anyway, Larry had a reach that extended into the next room and the skills to put it into action, as he did numerous times during this period.

Perhaps as a lark, or as a mild training exercise, his manager arranged a fight at Houston’s Astrodome between Holmes and what could charitably be described as a journeyman fighter named Tex Cobb. As the tapes reveal, Larry got quite a bit more than he or his manager bargained for.

Through 15 grueling rounds (not the more genteel 10 of today), Larry just pounded on Tex, bloodying him so badly that that venerable chunk of wood, Howard Cosell, declared that he would never again cover the sport.

The thing is, Tex wouldn’t go down, or, rather, he would go down, but would always get back up and beckon for more. There were even times during the late rounds when Larry’s arms got so tired from hitting Tex’s adamantine skull that he dropped his guard and got tapped a time or two himself.

I’ll always remember when the bell closed on the last round, and Tex threw up his arms, grinned his gap-toothed grin and yelled at the crowd, “Let’s party!”

Okay, I can work with that, following a review of what we have been doing on your behalf during these decidedly tumultuous times.

Macroeconomic Review

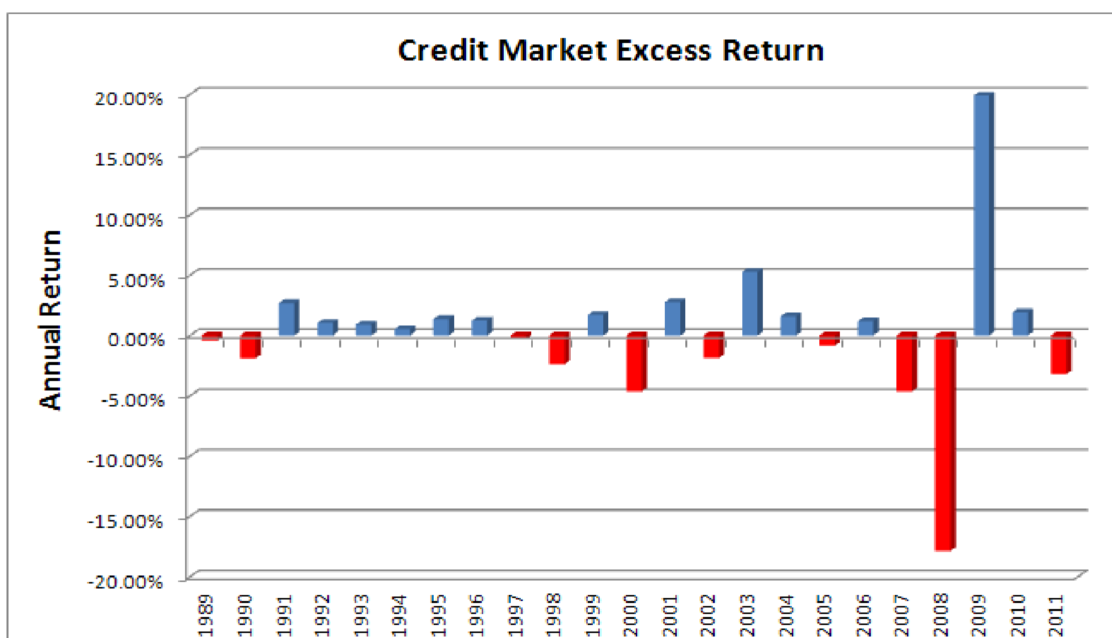
Third-quarter real GDP was 1.8% representing an increase from the previous quarter of 1.3%. Consumer spending (70% of GDP) was firm while inventories declined. In September, we differed from the consensus economic outlook of continued slow growth and forecast a pickup in the economic recovery. The big positive in the GDP report was the large drop in inventories and the pick-up in consumer spending. Our outlook for the economic recovery is now supported by improved retail sales, a pickup in the auto industry and the stirring of a recovery in the housing industry. Retail sales rose 0.1% in December, after a 0.4% jump in November. The strong performance of retail sales in November and December has given a lift to total retail sales in the fourth quarter. It is nearly certain that consumer spending in the fourth quarter will exceed the third quarter. For all of 2011, retailers enjoyed their strongest sales year since 1999 (up 6.5% from 2010) and quarterly auto sales of 13.48 million units were up from 12.48 million units the previous quarter. The obvious conclusion is that retail and auto sales should boost growth of consumer spending and real GDP in the fourth-quarter. Sales of new single-family homes increased 1.6% in November.

During the fourth-quarter, the yield curve was basically unchanged in both interest rate levels and shape:

	30-Sep	31-Dec	Change
3-monthTreasury Bills	0.02	0.01	-0.01
6-month Treasury Bills	0.05	0.06	0.01
2-year Treasury Note	0.24	0.24	0.00
5-year Treasury Note	0.95	0.83	-0.12
10-year Treasury Note	1.92	1.88	-0.04
30-year Treasury Note	2.91	2.89	-0.02
10-year vs. 2-year	1.68	1.64	-0.04

Corporate Securities

Corporate securities provided a modest positive impact on performance during the last three months. Corporate bond prices remained volatile during the quarter, however, as a strong October was followed by weakness in November before ending on the positive side in the final month of the year. The financial sector was both the most volatile and the weakest performer in 2011. The best sector was utilities. Despite the improvement in corporate bond prices in the final quarter, the overall corporate bond market underperformed comparable US Treasuries. Excess returns were a -3.22% for the full year. As shown in the following graph, the full year underperformance versus Treasuries is the fourth worse year since 1989 for the Barclays Capital Credit Index (the first year that excess returns were measured).



2011 relative performance was driven by two months, July and August, when corporate bonds underperformed by 5.25% as credit spreads widened from 1.53% to 2.38%. A large negative excess return for the sector has historically been followed by strong relative performance in the following year with the sole exception of the 2007-2008 period. The volatile returns during the second-half of the year reflected the market reaction to several factors: (i) growing concern over European sovereign credit risk, (ii) potential slowdown in global growth and (iii) worries over the spill-over impact of these factors on US growth and corporate cash flow.

We entered 2012 with an overweight exposure to corporate bonds. This position is driven by a number of factors. First, corporate bond spreads at 2.34% over comparable US Treasuries fairly compensate investors even if the United States enters a mild recession (which we do not expect). Second, corporate financial fundamentals remain extremely strong as companies continue to generate significant cash flow, strong balance sheets and consistent

earnings as evidenced by approximately 75% of companies reporting positive earnings surprise during the fourth quarter. Third, our quantitative screen, which utilizes equity prices, volatility, and debt levels, confirms that current credit spreads more than compensate for the credit risk.

The following issuers are illustrative of our approved buy list and may be held or purchased in the future. Investment positions are well-diversified and characterized by strong financial fundamentals. For instance, within the industrial sector, Raytheon (rated A3/A-) was added in December. This defense company has cash flow coverage of 20 times, and a positive earnings surprise. Their bonds provide 24 basis points excess spread over their credit risk. Verizon (A3/A-)/Verizon Wireless (A2/A-) the leading wireless provider in the United States combines solid cash flow generation with attractive valuations (EBITDA/Interest Coverage of 11 times, and 24 basis points of Excess OAS). While in the utility sector names like Duke Energy (A2/A) and Sempra Energy (Baa1/BBB+) provide stable financial performance, less spread volatility and attractive incremental income for our portfolios as both are currently trading at over 30 basis points of excess spread.

Even the worst performing sector in 2011, financial companies, provide numerous investment opportunities. As shown in the table below, US banks have dramatically improved their fundamentals since the nadir reached during 2009.

	Tier 1 Common Capital (%)	Net Charge-Offs to Average Loans	Non-Performing Assets % Equity + Reserves	Return on Common Equity
3rd Quarter 2011	10.5%	1.77%	13.45%	10.10%
2009	9.2%	12.60%	22.23%	1.50%

Banks improvement over the past several years coupled with spreads of 3.61% on average, provide an attractive investment opportunity. Spreads are likely to remain volatile until early in the second quarter when the Federal Reserve releases the results of their new enhanced stress tests. These tests are harsh and include a one-year recession ending third-quarter of 2012 with an 8% decline in GDP and an unemployment peak of 13% in 2013. It also includes a severe spike in volatility, trading losses at 2008 levels, significant declines in emerging markets, a prolonged euro zone recession ending during 2013 and Euro sovereign defaults. We expect that even under this stress scenario the combination of future earnings, excess loan reserves and current strong capital positions provide an adequate protection and the major US banks will meet the maximum Basel 3 Tier Common Capital Ratio of 9.5% required by 2018. Goldman Sachs and Morgan Stanley are both well positioned and have capital positions that should easily exceed the minimum capital levels even under the stress scenario. Both companies have been under price pressure in the equity and debt markets over the last six months but we expect them and other financial names to provide relatively strong performance over the coming months.

Mortgage-Backed Securities

Mortgage-Backed Securities ("MBS") modestly outperformed comparable US Treasuries during the fourth quarter. At the beginning of the quarter, our portfolios included a focus on GNMA securities that provided favorable yields and short weighted average lives. As the quarter proceeded, the exposure to GNMA securities was reduced as they outperformed and became less attractive. These positions were moved into FHLMC and FNMA securities with coupons generally falling between 4.5%-5.5%. Our current selection process is focused on identifying investments with relatively attractive option adjusted spreads with stable and short weighted average lives.

Over the past several months, our exposure to MBS has been based on several factors:

(1) The Federal Reserve commitment to maintaining stable short-term interest rates should result in less interest rate volatility. This environment is attractive for MBS as low volatility reduces the value of the prepayment option of the underlying mortgages.

(2) Net Agency MBS issuance is projected to be a negative $100 billion as consumer deleveraging continues.

(3) US banks and Federal Reserve demand for MBS will further reduce the available supply.

(4) The Home Affordable Refinance Program ("HARP") has increased the share of loans with LTV greater than 80% in recent vintages. This high LTV will result in reduced callability for newly issued MBS, as they are effectively burnt-out at issuance.

Strong demand for this high quality, liquid sector coupled with both limited supply and stable interest rates should help performance of the sector in the next quarter.

During the fourth quarter, we added a select number of floating rate credit card securities. Each of the investments was the senior tranche of the structure, rated "AAA", highly liquid and from only the highest quality issuers-for instance American Express. These securities provide a high quality alternative to cash with better income.

In Conclusion

I'm not going to expend many words railing about the global economy, the European bomb that continues to detonate and the usual blah, blah that characterizes daily prognostications and attendant portents of doom. In fact, I'm all but finished with the topic, except to say…

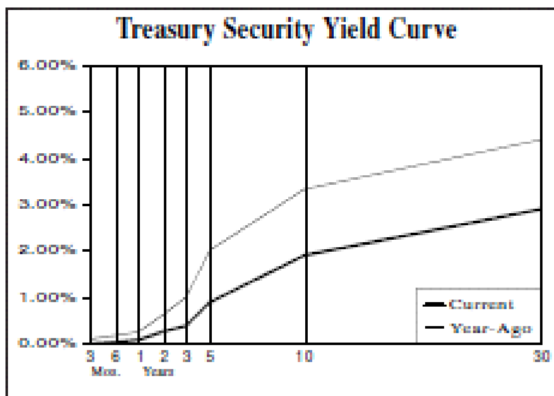
In one corner, we have the proverbial "Bill Come Due," a mammoth entity that demands payment for the social programs, entitlements, pension and banking and housing collapses and other fiascos of the relatively recent past. In other words, bond buyers, sellers and holders.

This is a mean fighter, more than willing to take out the little people…Greece, Ireland, perhaps Italy…and those not so little, the European Union. Or at least it may appear so in the days to come.

Then there's Tex, an amalgamation of all the cities, counties and countries that are finding that the patch of ground they inhabit is very rough indeed. They've begun to take the unremitting pounding of unfunded liabilities and likely will be quite well used by the time this cycle closes. But they will endure and return and they will party.

There is no other choice. The game is a relatively closed system, with all of its participants knowing one another and what's at stake. Collectively, we're simply going through the admittedly painful process of trying to endure. But, money will be made. It may take a while. Cracks will appear that will open an opportunity, and that's where we will be.

	Recent (12/28/11)	3 Months Ago (9/28/11)	Year Ago (12/29/10)
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)	0.19	0.42	0.28
3-month Libor	0.58	0.37	0.30
Bank CD's			
6-month	0.22	0.17	0.30
1-year	0.34	0.21	0.48
5-year	1.15	1.26	1.55
U.S. Treasury Securities			
3-month	0.01	0.01	0.12
6-month	0.05	0.03	0.19
1-year	0.10	0.10	0.27
5-year	0.91	0.94	2.03
10-year	1.92	1.98	3.35
10-year (inflation-protected)	-0.11	0.11	1.02
30-year	2.92	3.07	4.43
30-year Zero	3.02	3.28	4.71

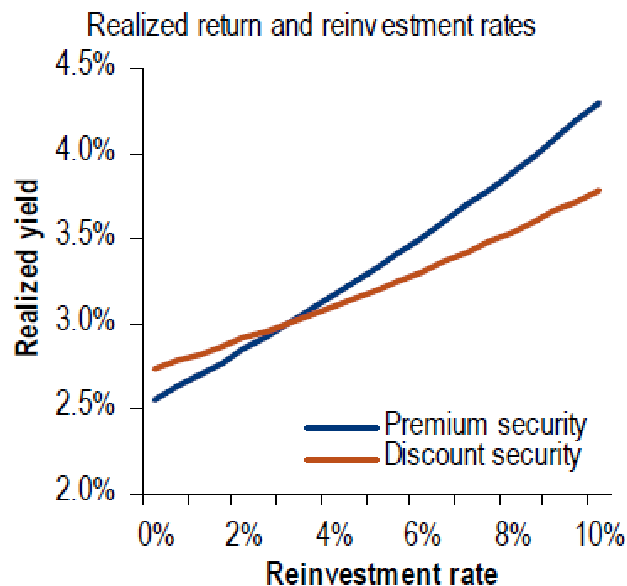


Source: Value Line, Inc.

	Recent (12/28/11)	3 Months Ago (9/28/11)	Year Ago (12/29/10)
Mortgage-Backed Securities			
GNMA 5.5%	1.12	1.62	3.08
FHLMC 5.5% (Gold)	2.12	2.08	3.13
FHLMC 5.5%	1.99	1.97	2.94
FHLMC ARM	2.37	2.50	2.80
Corporate Bonds			
Financial (10-year) A	4.17	3.87	4.76
Industrial (25/30-year) A	4.26	4.50	5.50
Utility (25/30-year) A	4.14	4.34	5.78
Utility (25/30-year) Baa/BBB	4.78	4.98	6.10
Foreign Bonds			
Canada	1.96	2.20	3.16
Germany	1.89	2.01	3.02
Japan	1.00	1.00	1.17
United Kingdom	2.01	2.55	3.57
Preferred Stocks			
Utility A	5.37	5.24	5.79
Financial A	6.71	6.45	6.48
Financial Adjustable A	5.48	5.48	5.48
TAX-EXEMPT			
Bond Buyer Indexes			
20-Year Bond Index (Gos)	3.92	3.85	5.00
25-Bond Index (Revs)	5.01	4.96	4.52
General Obligation Bonds (Gos)			
1-year Aaa	0.22	0.24	0.44
1-year A	1.06	0.99	1.36
5-year Aaa	0.97	1.04	1.74
5-year A	2.07	2.05	2.88
10-year Aaa	2.12	2.15	3.44
10-year A	3.23	3.42	4.39
25/30-year Aaa	3.86	3.87	4.90
25/30-year A	5.24	5.53	5.90
Revenue Bonds (Revs) (25/30-Year)			
Education AA	4.56	4.56	5.27
Electric AA	4.73	4.92	5.28
Housing AA	5.29	5.55	6.11
Hospital AA	4.87	4.90	5.45
Toll Road Aaa	4.54	4.58	5.33

Under Current Economic Market Conditions
Vanderbilt Ave. Asset Management (VAAM) Prefers Discount Bonds

A discount bond could be preferable to a premium bond for investors who plan to re-invest the interest income in times when the reinvestment rate is less than the yield to maturity. The return earned on the re-invested coupons is an important part of the total return for people saving for long-term goals such as retirement or a college education. Since premium bonds pay higher coupons than otherwise similar discount bonds, the rate paid on those reinvested coupons—the reinvestment rate—is a more important consideration than for a bond priced at a discount. The higher coupon payments on the premium bonds work to the advantage of investors when the coupons are re-invested at high rates, but works against them when the coupons are re-invested at low rates. The Chart below gives an example. Both bonds mature in 10 years and have a 3.00% yield-to-maturity. The premium bond pays a 4.00% coupon, and the discount bond pays a 2.00% coupon. If the coupons are re-invested at the 3.00% yield to maturity, the realized yield on both bonds would also be 3.00%. But in many cases, especially when the yield curve is steep, the re-investment rate is lower than the stated yield to maturity. In those cases, the investor would generally be better off with the discount bond. With a 1.00% re-investment rate over the 10-year horizon, the return for the discount bond is 2.82%, while the return for the premium bond is 2.70%. In contrast, the premium bond with its high coupons outperforms when the reinvestment rate exceeds the yield-to-maturity.



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