VANDERBILT Ave. ASSET MANAGEMENT

3rd Quarter 2012

In September, just in time to ignite a global rally in equities, the Fed announced a third round of quantitative easing calling for a monthly purchase of $40 billion in mortgage-backed securities. This program will continue indefinitely until "the outlook for the labor market… improves substantially."

So-called QE3, this effort to inject liquidity into the economy and jump-start an anemic recover is different in form from previous quantitative programs, which were limited to a fixed amount of total intervention. Monetary policy is now associated directly with unemployment in that its explicit goal is to increase employment. However, the Fed's forecast for unemployment shows only a marginal improvement:

2012	**2013**	**2014**
8.0-8.2	7.6-7.9	6.7-7.3

The stock market gathered momentum on the release of the FOMC minutes. Many market participants have made the argument that tying Fed policy directly to job growth is a major positive step.

We disagree.

First, we suspect that fed policy has entered the region of diminishing returns. Secondly, it might very well be the case that monetary policy has little effect on the economy's level of employment. There are certain structural issues in the labor markets that are not sensitive to Fed policy. At the end of the day, we may reach a point where the Fed's credibility is questioned.

The FOMC Committee also extended the period over which short term interest rates will be held at zero. This added another six months or so to the timeline that the Fed delivered in its August FOMC statement. Our question here is straightforward: If this policy has not worked over the past two years, why will it all of a sudden work now? Low interest rates do not benefit all market segments.

In fact, this policy shortchanges savers, who rely on adequate yields to maintain or improve their standards of living. Ironically, it also serves as a disincentive to bank lending as banks can often get better returns by investing elsewhere.

The yield curve was slightly steeper as rates declined less as maturities lengthened. The following outlines interest rate changes for the quarter:

	30-Jun	30-Sep	Change
3-monthTreasury Bills	0.08	0.09	0.01
6-month Treasury Bills	0.15	0.13	-0.02
2-year Treasury Note	0.30	0.23	-0.07
5-year Treasury Note	0.72	0.63	-0.09
10-year Treasury Note	1.65	1.63	-0.02
30-year Treasury Note	2.75	2.82	0.07
10-year vs. 2-year	1.35	1.40	0.05

Corporate Securities

Investors were rewarded during the third-quarter as returns in the sector exceeded comparable U.S. Treasuries by 2.96% as measured by the Barclay's Investment Grade Corporate Bond Index, which includes all maturities. Shorter maturities enjoyed 1.35% excess returns as measured by Merrill Lynch during the period. Banks, brokerage firms, and life insurance companies continued to outperform other corporate sectors. Media, cable and telecommunications companies were also stand-out performers. Mining, manufacturing, and utility companies trailed the overall corporate market, but even these sectors easily outperformed Treasury bonds. Ongoing concerns with the direction of global growth continued to wear on the first two, while utilities tend to be a safe haven that will lag in a strong corporate bond market rally.

Your portfolio remained significantly overweight to corporate bonds throughout the period. Strong second quarter earnings reported during the period continued the improving financial fundamentals of U.S. corporations. For instance, over 70% of S&P 500 companies reported better than expected or in line earnings surprise. Credit metrics that we focus on remain at historically favorable levels. Debt to EBITDA (earnings before interest, depreciation and amortization) is just 2.00 times, interest coverage at over 10 times and profit margins are at a twenty-year high of 8.6%. Cash continues to build on corporate balance sheets-easily exceeding $2 trillion. These ratios are virtually identical to the prior quarter. At this point in the economic cycle, we do not expect fundamentals to materially improve from current levels as companies will deploy funds to increase dividends and stock buy-backs. Despite this year's spread tightening, our quantitative screen, which calculates a fair value spread and compares to an observed CDS spread for individual corporate bond issuers, confirms that this tightening was driven by improving credit quality and that even after the outperformance year-to-date, corporate bonds remain relatively attractive versus U.S. Treasuries.

The financial sector has been the strongest performing sector this year. Performance has been driven by continuing improvement in the sector's financial fundamentals and extremely attractive valuations. The top 25 U.S. banks saw net charge-offs fall to 1.35% of average loans as compared to 2.14% in 2009 and nonperforming assets as a percentage of capital reserves of 11% versus over 22% in 2009. Tier 1 Common Capital Ratio is a solid 10.8% (up from 7.9% in 2009). Within your portfolio, Citigroup and Bank of America have been stand out performers. Capital ratios for both firms have improved dramatically since the financial meltdown (now 11.2% for BAC, and 12.7% for Citigroup). At the beginning of the year, the bank sector had an average option adjusted spread of 3.61% as compared to the overall spread of 2.34% for the corporate bond market. These spreads have declined to 1.72% for banks versus 1.56% for the overall market. Financial firms are unlikely to enjoy the strong relative performance of the first nine-months in the final-quarter, with performance more closely correlated to the overall performance of the corporate bond market. Ford Motor Credit was purchased during the quarter. Ford has strong cash flow as EBITDA to interest coverage exceeds 17 times and valuation is very attractive as measured by our quantitative model at 1.29% of excess spread over fair value. Even though relative performance is unlikely to replicate the first nine months of the year, corporate bonds remain attractive as compared to U.S. Treasuries and we remain overweight to the sector.

Mortgage-Backed Securities

Mortgage-Backed Securities (MBS) handily outperformed comparable U.S. Treasuries during the third quarter. In mid-September, Ben Bernanke announced a very aggressive QE3, which included Federal Reserve purchases of $40 billion of MBS per month. Accordingly, MBS spreads versus Treasuries have narrowed to historically tight levels.

Using our rigorous selection process, we invest in MBS which exhibit favorable option adjusted spreads (OAS) and stable prepayments. During the third quarter, we increased overall exposure to MBS to capitalize on their relatively attractive yields and to benefit from any positive impact of QE3. While your portfolio includes both FNMA & FHLMC securities, we continued to favor FHLMC securities, which provided more attractive yield / OAS than comparable coupon FNMA securities. Also, the average coupons purchased were lower (4% & 4.5% in Q3 vs. 4.5% & 5% in Q2). We continue to favor 15-year maturities due to their shorter durations, relatively stable prepayments, and more predictable cash flows, given a wide range of potential interest rate scenarios.

The Federal Reserve has reiterated its commitment to maintaining low interest rates for the foreseeable future. MBS should continue to benefit from this stable/low-volatility interest rate environment, as the value of the embedded prepayment option in the underlying mortgages is reduced. However, due to the current tight spreads exhibited in the sector post-QE, we do not anticipate adding significantly to your current exposure. Instead, we will focus on optimizing returns within the sector by focusing on the best relative value (i.e. highest OAS, best overall yield and stable prepayments).