4th Quarter 2012

Vanderbilt's outlook for economic growth greater than the consensus has gained traction. We are predicting growth of 3%-3.5% for 2013. Fourth-quarter GDP growth of 3.1% was lead by increased consumer spending (70% of overall GDP). The consensus forecast is lower than that of VAAM's due to three primary factors: the consumer, monetary policy and the fiscal outlook. The consensus view is that continued deleveraging by the consumer will mute spending. However, we think an improved consumer balance sheet will allow consumer spending to bounce off the bottom and afford the wherewithal for improved spending. Evidence of this is seen in an improved housing market, higher auto sales and a better retailing environment. Also, the consensus was that the Federal Reserve would run out of additional monetary stimulus tools once they took interest rates to near zero. However, their asset purchases of mortgage-backed securities and US Treasuries (currently at a rate of $85 billion per month) has injected funds into the economy and banking system. Another important support to the economy is the continued improvement in the credit markets. Banks have indicated an increased willingness to lend as evidenced by the 12.8% annualized rate of increase in bank loans to business for the most recent data. In addition, the Federal Reserve linking of short-term interest rates to an objective of 6.5% unemployment tilts the Fed's objective more towards growth vis-à-vis inflation. Finally, the initial resolution of the fiscal cliff should improve business confidence and lead to a reacceleration of business investment.

Despite all the publicity the fiscal cliff has received, we believe a successful resolution of the federal debt limit in early 2013 is more important. The ratings agencies (Moody's and Standard & Poor's) have indicated that they need to see progress not only in addressing the deficit/debt levels but also a resolution of the debt ceiling. The debt ceiling issue combined with continued pressure to reign in expenditures promises further negotiations to expand tax revenues (perhaps through reform of the tax code) along with slowing the growth of entitlement programs.

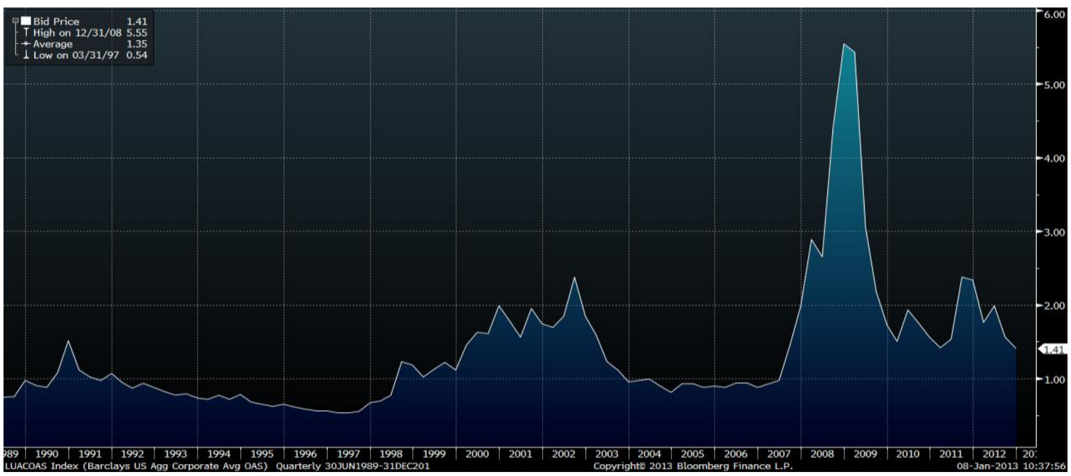
During the quarter, the yield curve slightly steepened as long rates rose more than the shorter end of the market. The following outlines interest rate changes for the fourth-quarter:

	30-Sep	31-Dec	Change
3-monthTreasury Bills	0.09	0.04	-0.05
6-month Treasury Bills	0.13	0.11	-0.02
2-year Treasury Note	0.23	0.25	0.02
5-year Treasury Note	0.63	0.72	0.09
10-year Treasury Note	1.63	1.76	0.13
30-year Treasury Note	2.82	2.95	0.13
10-year vs. 2-year	140	151	11

Corporate Securities

Corporate bonds closed out a strong year with a solid outperformance versus comparable U.S. Treasuries. For the fourth-quarter, the sector provided extremely positive excess returns. As has been the case over the last 12 months, financial companies' returns easily outpaced the industrial and utility sector. The latter two areas provided significantly less relative performance than the former but were still positive compared to U.S. Treasuries. Within the industrial sector, the weakest performers were the more defensive sectors such as pharmaceuticals, defense, railroads and food and beverage companies. These industries tend to be less economically sensitive and most entered the quarter with spreads significantly tighter than the overall corporate market. For instance, food and beverage companies had an average spread of 1.07% versus 1.43% for all industrial securities. The strong results of the corporate sector were driven by continued solid earnings and cash flow and a gradual reduction in worries over the global economy.

Your portfolio's overweight allocation to corporate bonds was maintained throughout the quarter. Corporate financial fundamentals continue to support the compression in bond spreads. During the third-quarter, over 70% of S&P 500 companies reported earnings in line with or better than expected. Cash flow generation is stagnating somewhat but remains strong. As a result, interest and debt coverage ratios remain near all time best levels. It is unlikely that these ratios will materially improve from current levels as companies are likely to increase dividends and/or stock buy-backs. The largest near term risk is significant debt financed equity purchases or leveraged buy outs last seen in 2005 through 2007. However, the impact on the overall corporate bond market is likely to be relatively mild. Our quantitative screen, which calculates a fair value spread and compares to an observed CDS spread for individual corporate bond issuers, has continued to indicate that the tightening of spreads of the corporate index from 2.34% at the beginning of the year to 1.41% at year-end has been driven by and supported by an improvement in credit quality. Credit spreads are now near the average spread for the period beginning 6/30/1989 (shown below).



Historically spreads have compressed significantly through this average with the tightest level being 0.54% during the first quarter of 1997. A return to this level is unlikely but further improvement is expected.

Financial companies were the stand-out performers in the corporate sector for both the fourth-quarter and the full-year. These firms entered the year with spreads over 0.70% above the overall corporate bond market. By year-end, their spread had compressed to just 0.14%. This movement was driven by solid financial performance. For instance, the largest 25 U.S. banks' nonperforming assets as a percent of total capital and reserves continued to decline reaching 10.9% as of the third-quarter and their tier 1 common capital ratio was 10.8% which is up from 7.9% in 2009. In addition, banks continue to resolve their legacy mortgage related legal issues. Goldman Sachs, Morgan Stanley and selective major banks remain overweight in your portfolio as they remain attractively priced and have the potential to continue to improve their fundamentals. The largest risk to the sector is the potential for further compression in the returns they earn on their assets versus what they must pay out on their liabilities. For banks, this is the net interest margin. The extended period of low long-term interest rates should be pressuring profitability, especially in the life insurance industry. These worries have kept us underweight to lower quality insurance companies during the past year. Our concerns were not shared by the market and did hurt our relative performance. Even though performance will not replicate 2012, corporate bonds are expected to outperform U.S. Treasuries. We, therefore, remain overweight to the sector.

Mortgage-Backed Securities

Mortgage-backed securities (MBS) modestly underperformed comparable U.S. Treasuries during the fourth-quarter. In December, the Federal Reserve announced the continuation of its purchases of $40 billion of MBS per month. Although this supportive environment is expected to keep MBS spreads at relatively tight levels, it is questionable whether the historical narrow spreads that had been experienced on the back of the original QE3 announcement will be seen again.

We decreased your overall exposure to MBS slightly during the fourth-quarter, as the yield advantage afforded by this asset class diminished. Your portfolio includes both FNMA & FHLMC securities of 15- & 30-year maturities. During the quarter, we shifted a portion of the MBS position from FHLMC to FNMA securities in an effort to enhance total return and liquidity. 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 exhibited its willingness to defend the current low interest rate environment. While MBS may continue to benefit from this stable and range bound rate environment, the risk/reward has become less positive. Accordingly, we expect to reduce your overall MBS exposure further during the first-quarter of 2013. Within the MBS sector, we will continue to seek the best relative value opportunities for your portfolio (i.e. highest OAS, best overall yield, stable prepayments and good liquidity).