VANDERBILT Ave.
ASSET MANAGEMENT

1st Quarter 2012

I had to wait for a group the other day and resorted to watching TV, ironically enough to avoid boredom. After watching the ten thousandth lion eat the ten thousandth zebra, or gazelle, or wildebeest, what have you, I chanced on a far distant RFD channel.

As I came to know, RFD stands for "Rural Farm District" and from what I gathered, they usually broadcast meat and crop reports, home gardening segments, hard core farming discussions and the like.

Today, they were discussing Integrated Pest Management (IPM), which refers to a series of interconnected, cooperative efforts aimed at achieving the strategic goal of minimizing pesticide use, while maximizing crop production. Simply fascinating.

With IPM, pesticides are used, but in close coordination with other management practices (mulching, irrigation, crop rotation, etc., ad nausea) to keep pests down to a level that makes best use of the pesticides that are used. For example, timing the use of specific, targeted pesticides during the emergence of certain insect pests while in their more vulnerable larval-to-adult stage of development, instead of later when they can be harder to get at. I could hardly shut my eyes.

Interestingly, there are also some times when you know that you shouldn't use pesticides at all; because you have managed well, you're going to get a good average yield even if the pests get a little on the side.

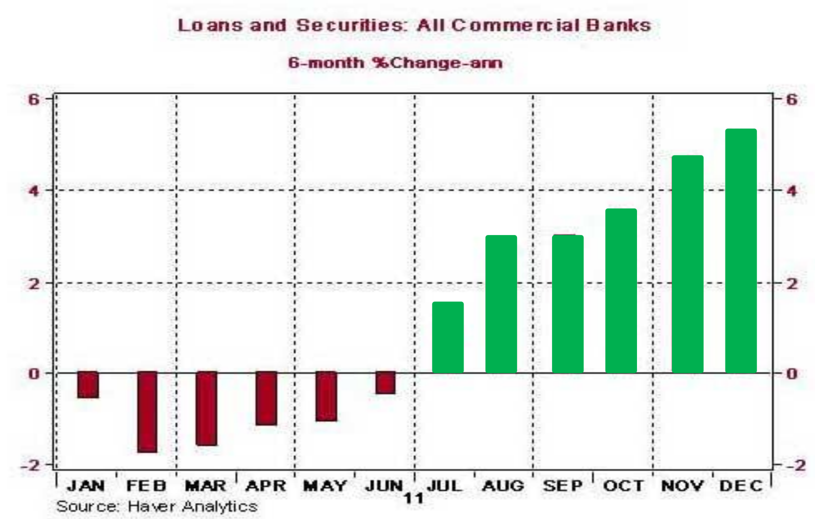
It's amazing to me still, even after so many years spent doing it, how many things resemble the practice of fixed income management.

More on this later, but first the quarter in review.

Macroeconomic Review

Fourth-quarter 2011 real GDP growth was 3.0% versus 1.8% growth in the previous quarter. Most of the growth came from inventory rebuilding. Also consumer spending (70%) of GDP rose 2.1%. Household debt hit a peak of $13.9 trillion in the first-quarter of 2008 which was equal to 100% of GDP. Household debt has shrunk since then providing the potential for greater consumer spending. For example, February consumer spending rose 0.8% which was the largest monthly increase since July, 2011. We continue to forecast economic growth above the consensus outlook with a full-year 2012 estimate of 3.5%. The labor market is slowly in fits and starts improving. Unemployment has declined to 8.2% and hourly earnings have gained 2.1% over the last year. However, the economy still has 5.2 million fewer jobs than four years ago

At its most recent meeting, the Federal Reserve gave a slightly more upbeat account of the economy than previously and said it planned to continue its efforts to improve growth. However, it continues to have a somewhat more subpar view of the economy compared to private forecasts in that it predicted "moderate growth" and just a gradual decline in unemployment. The bond market initially reacted adversely to the Fed minutes suggesting QE3 is unlikely barring a deterioration of the economy. Even prior to this, such hopes were misplaced in our view. QE was always intended to help get the recovery on a sustainable path. Admittedly, the U.S. economy continues to operate below full capacity and underlying inflationary pressures are tame. Although the Fed had injected a tremendous amount of liquidity, the banks were not lending. Credit was not being created, and the economy was lagging. However, consumer spending and capital spending are on positive trends, and credit growth (see chart below) has picked up noticeably in recent months, underscoring that the monetary transmission mechanism is now starting to work. Unless bond yields move materially higher, or the economy loses significant momentum, investors should not bet on QE3.

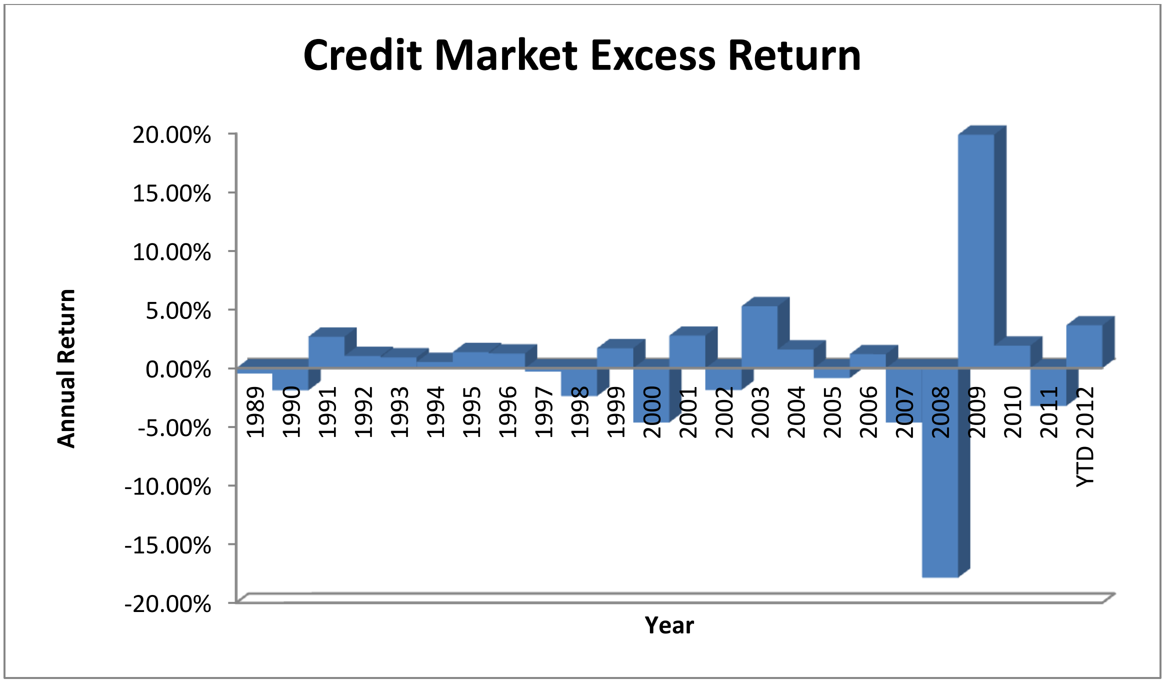


During the first-quarter, the yield curve rose and became steeper as interest rates increased across the maturity spectrum:

	31-Dec	30-Mar	Change
3-monthTreasury Bills	0.01	0.07	0.06
6-month Treasury Bills	0.06	0.13	0.07
2-year Treasury Note	0.24	0.33	0.09
5-year Treasury Note	0.83	1.04	0.21
10-year Treasury Note	1.88	2.21	0.33
30-year Treasury Note	2.89	3.34	0.45
10-year vs. 2-year	1.64	1.88	0.24

Corporate Securities

The Corporate bond sector provided the best returns within the fixed income market during the first-quarter of 2012. The year has started strong as spreads compressed versus comparable US Treasuries during each month of the quarter. By the end of the quarter, corporate bonds out to three-years maturity had an average return of 1.85% as measured by the Merrill Lynch Index versus a negative 0.10% for comparable maturity US Treasuries. Financial sector securities were the stand out performers during the quarter as they rebounded from a difficult prior year. Both industrial and utility bonds enjoyed relatively strong performance but both trailed the outstanding performance turned in by the financial industry. Your portfolio's overweight to the sector had a significant positive impact on performance during the quarter. The following graph of the Barclays Credit Index Excess Return since 1989 shows that the first-quarter performance fully offset the underperformance of the sector last year.



During the quarter, your portfolio's corporate exposure was modestly reduced; however, it remains significantly overweight to the sector. This position continues to be based on attractive valuation with corporate spreads at 1.76% over comparable US Treasuries. These spreads are attractive in light of continued strength in the financial fundamentals of US companies in the fourth-quarter led by significant cash flow generation and earnings as approximately 70% of companies reported positive earnings surprises. During the past year, industrial companies' cash flow covered their interest expense by over 10 times and total debt to cash flow was only 1.5 times, both near 20 year best levels. In addition, our quantitative screen, which utilizes equity prices, volatility, and debt levels, confirms that despite the spread tightening of the first quarter, credit spreads continue to compensate investors for credit risk.

Several illustrations of industrial names on our buy list include Freeport McMoran-a mining company with 24 times EBITDA/Interest Coverage. Their bonds provide 75 basis points excess spread over their credit risk. Johnson Controls, an auto supplier, has strong cash flow versus its peers with 13 times cash flow to interest and just 1.9 times debt to cash flow. It also remains attractively valued at 40 basis points of excess spread at quarter end. During the quarter, utilities slightly underperformed other industrial sectors. The sector, however, provides stable financial fundamentals and attractive spreads. Several names either in your portfolio or on our buy list include Georgia Power, a subsidiary of the Southern Company, which combines stable financial performance and an attractive valuation (54 basis points of excess spread).

Financial companies' performance benefited from ongoing improvement in their loan portfolios and strong capital position. In addition, the Federal Reserve completed their enhanced stress test for banks at the end of the quarter. As mentioned last quarter, the test includes a one year recession, an 8% decline in GDP, an unemployment peak of 13% in 2013, Euro sovereign defaults and trading losses at 2008 levels. All of the institutions held in your portfolio were able to pass the test. Citigroup was not permitted to implement their aggressive capital plans of share buybacks and a higher dividend. Despite dramatic spread tightening and outperformance of the sector during the first quarter, most companies remain attractively priced. For instance, JPM Chase and Goldman Sachs are still "cheap" as their bonds provide 0.49% and 0.96% of excess spread at the end of the quarter. We do not expect as strong relative performance in the coming months but their spreads versus comparable US Treasuries is likely to gradually compress.

Mortgage-Backed Securities

Mortgage-Backed Securities (MBS) outperformed comparable US Treasuries during the first quarter. Your portfolio includes both FNMA & FHLMC securities that provide favorable yields and short weighted average lives, with coupons generally in the 4%-5% range. Our selection process highlights investments with relatively attractive option adjusted spreads.

During the quarter, we increased exposure to MBS modestly to capitalize on the continued yield advantage. The Federal Reserve has reiterated its commitment to maintaining stable short-term interest rates in the near-term (i.e. continued low volatility). This environment is attractive for MBS, as low volatility reduces the value of the prepayment option of the underlying mortgages.

In the second-quarter, we anticipate repositioning a portion of the MBS to shorter duration structures with more stable cash flow characteristics to reduce the potential impact of any interest rate rise on your portfolio. Overall, we believe that continued demand for MBS, which are highly-rated and very liquid, coupled with limited supply should help performance of the sector in the next quarter.

In Conclusion

In any good IPM plan, as with any investment program, there are charts and graphs that depict what was done, how results were monitored, how the various offensive/defensive practices were helping or hindering one another and so on. But there was one graph that seemed familiar. It looked kind of like what we might call a “river chart” for investments of greater or lesser risk. The surface of the river, the top line, was called, unsurprisingly, the “upper threshold” for pesticide usage, and the lower, the “lower threshold”.

If field research showed that the average incidence of pest infestation fell in a range above the upper threshold, you didn’t need any pesticides; the crop yield would be profitable without spending the money needed to remove a relatively minor problem. Sometimes you know what you’re doing so well that you stay consistently above the fray.

On the bottom of the graph, the story was quite the opposite. If the farmer was neglectful and let the pest population exceed a certain predefined limit, he fell below this threshold. If so, there nothing to be done but start again next year. No amount of pesticide or best management practice could rescue the investment.

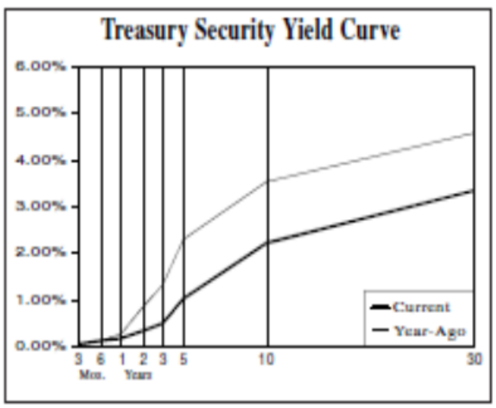
In the middle, of course, was waged the take-no-prisoners war that marked each day for most farmers. Here, finely tuned, coordinated practices could work in concert to eliminate the pest of the moment, or at least reduce its influence. In this middle, almost all commercial crops and their attack-pests reside. The winners are the vigilant, the wily, the persistent and those who can see all sides of the picture and put the pieces together. Occasionally, the humans win, as well.

Excepting the human part, this is roughly similar to fixed income investment management. We try to stay above the upper threshold by making durable choices that minimize or eliminate the need for corrective moves, coordinate everything in our formidable arsenal to win the war in the middle and completely avoid the bottom by not neglecting anything.

Anyway, my party arrived soon after the program ended and someone launched into an impassioned defense of bi-valves. It’s New York, after all, where everyone has something to say about everything.

I knew just how to respond.

	Recent (4/04/12)	3 Months Ago (1/04/12)	Year Ago (4/06/11)
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)	0.32	0.25	0.27
3-month Libor	0.47	0.58	0.29
Bank CD's			
6-month	0.22	0.22	0.29
1-year	0.33	0.34	0.47
5-year	1.14	1.16	1.71
U.S. Treasury Securities			
3-month	0.07	0.01	0.06
6-month	0.14	0.05	0.13
1-year	0.19	0.10	0.28
5-year	1.04	0.88	2.31
10-year	2.23	1.98	3.55
10-year (inflation-protected)	-0.09	-0.14	0.96
30-year	3.36	3.03	4.60
30-year Zero	3.59	3.13	4.92



Source: Value Line, Inc.

	Recent (4/04/12)	3 Months Ago (1/04/12)	Year Ago (4/06/11)
Mortgage-Backed Securities			
GNMA 5.5%	1.52	0.99	2.84
FHLMC 5.5% (Gold)	2.33	2.03	3.46
FHLMC 5.5%	2.18	1.86	3.40
FHLMC ARM	2.36	2.35	2.62
Corporate Bonds			
Financial (10-year) A	3.66	4.25	4.85
Industrial (25/30-year) A	4.40	4.33	5.59
Utility (25/30-year) A	4.35	4.22	5.66
Utility (25/30-year) Baa/BBB	4.75	4.95	6.16
Foreign Bonds			
Canada	2.13	1.99	3.42
Germany	1.79	1.92	3.43
Japan	1.03	0.99	1.30
United Kingdom	2.21	2.05	3.76
Preferred Stocks			
Utility A	5.29	5.11	5.89
Financial A	6.46	6.38	5.84
Financial Adjustable A	5.48	5.48	5.48
TAX-EXEMPT			
Bond Buyer Indexes			
20-Year Bond Index (Gos)	4.02	3.88	5.00
25-Bond Index (Revs)	4.85	4.97	5.56
General Obligation Bonds (Gos)			
1-year Aaa	0.20	0.22	0.37
1-year A	1.05	1.07	1.21
5-year Aaa	1.04	0.92	1.85
5-year A	2.07	2.06	2.84
10-year Aaa	2.26	2.07	3.41
10-year A	3.39	3.12	4.48
25/30-year Aaa	3.72	3.80	4.84
25/30-year A	5.21	5.20	6.13
Revenue Bonds (Revs) (25/30-Year)			
Education AA	4.54	4.53	5.19
Electric AA	4.72	4.70	5.30
Housing AA	4.97	5.26	6.19
Hospital AA	4.60	4.72	5.65
Toll Road Aaa	4.48	4.53	5.34