VANDERBILT Ave.
ASSET MANAGEMENT

3rd Quarter 2010

Raison d'être means "reason or justification for existence." And what does this fairly arcane phrase have to do with the bond market?

Not a lot, actually. But, at this time of year, as in any other, when reflections on the past and projections of the future are common fare, it seemed appropriate to restate our concept of fixed-income investment management and examine what reasons or justifications can be provided for our existence as fixed-income investment managers.

Put simply, our principal raison d'être is to preserve and protect our clients' principal against a potentially hostile economic environment that would seek to erode it. Within the restraints imposed by the need for capital preservation, we also seek to generate competitive investment returns that will help our clients achieve their near and long-term financial objectives. Taken together, these reasons for being define fixed-income investment management as practiced by Vanderbilt Avenue Asset Management.

But, you may opine, I can do what you do simply by parking my money in a CD, a money market fund, a bond mutual fund, or some assortment of individually-owned bonds. Well, you can and you can't. You can if you're willing to cast your lot with, and assume the same risks as, the thousands of like-minded investors who utilize these investment alternatives (often with little long-term success and high fee structures). You can't, if you're inclined to break with the pack in search of higher risk-adjusted returns.

Part of where we add value is through individual portfolio *management*. Each client's financial objectives are unique to their respective risk tolerances, near and long-term income needs, flexibility, sources of income, credit quality constraints and many other factors. As with snowflakes, no two are alike. Unique objectives can't often be satisfied with mass-delivered solutions. We construct and manage unique portfolios to satisfy each client's unique objectives.

Sure. Sure. Sure. Everyone says that, but what does this mean to me?

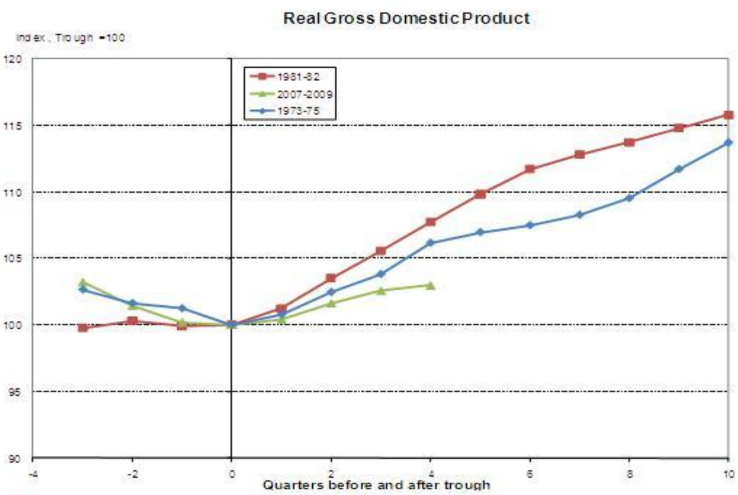
I can answer only for our firm. We don't like to worry. We like to sleep at night. This self-serving attitude works to the benefit of our clients and guides the investment strategies we develop and implement on their behalf. To avoid worry and increase sleep, we don't invest in bonds that may at times offer the potential for greater returns, but also represent greater risk than is tolerable in light of our long term objectives. More risk equals more worry. We don't like to worry. And, we like to sleep at night.

By sticking with what we know best, we know we're working with financial instruments that offer the greatest safety and liquidity in up or down markets. Through our research, we're comfortable that we're investing in bonds that can continue to pay principal and interest under even the most severe economic scenarios. We're not always right (who is?), but usually, even frequently, we are.

Macroeconomic Review

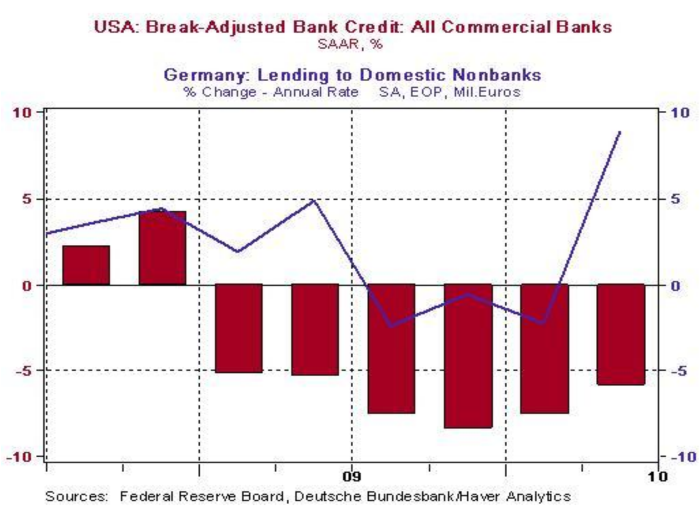
Vanderbilt was among the first firms to forecast the probability of a double dip recession occurring. The sluggish recovery has resulted in an ongoing soft labor market. This has impeded job creation and incomes. As a result the consumer sector (70% of GDP) has remained relatively weak. The deleveraging process continues as consumer debt is being paid down. Unemployment at 9.6% is likely to remain a long-term problem. Especially since a relatively large portion of the unemployed are long-term and will be more difficult to get off the unemployed rolls. During the summer the consensus forecast started to converge to our forecast.

However, the probability of a double dip recession has lessened. The recession that commenced December 2007 ended June 2009. The 18-month recession is the longest in the post-war period. Real GDP rose 6.2% and 7.7% at the end of four quarters of economic recovery following the 1973-75 and 1981-82 recessions. GDP has only risen 3% after four quarters of economic growth this time (see chart).



The economy could possibly surprise on the upside. While the second-quarter appears to have experienced a further growth deceleration to 1.7% (versus 5% fourth-quarter 2009 and 3.7% for first-quarter 2010), one could reach the opposite conclusion. Although growth slowed in the second-quarter, this reflected a surge in imports and a maturing of the inventory cycle. When it comes to final demand growth, this is an area of the economy that gathered steam in the quarter. Final sales to domestic purchasers (excludes inventories) accelerated sharply in the second-quarter. These sales rose at an annualized rate of 4.3% which was the fastest pace since the first-quarter of 2006. Growth would have been stronger in the second-quarter if it were not for the 32.4% annualized surge in imports which statistically subtracted from real GDP growth. Since the mid-1970s, such a rapid pace of import growth has only been seen in the recovery phases following the recessions of 1973-75 and 1981. We judge the surge in imports to be a sign of recovery rather than a sign of economic weakness.

A new mix of economic drivers is shaping US growth. Exports are driving GDP growth. During the first and second- quarters of 2010, exports jumped by an impressive annualized rate of 11.4% and 9.1% respectively, by far the strongest GDP component. Strong exports almost fully offset the weaker than average contributions from the consumer and housing sectors. A look at recent growth in Germany could provide a clue to future US growth. Germany grew at an annualized 9.0% during the second-quarter. The chart below contrasts the change in bank credit for both Germany and the US.



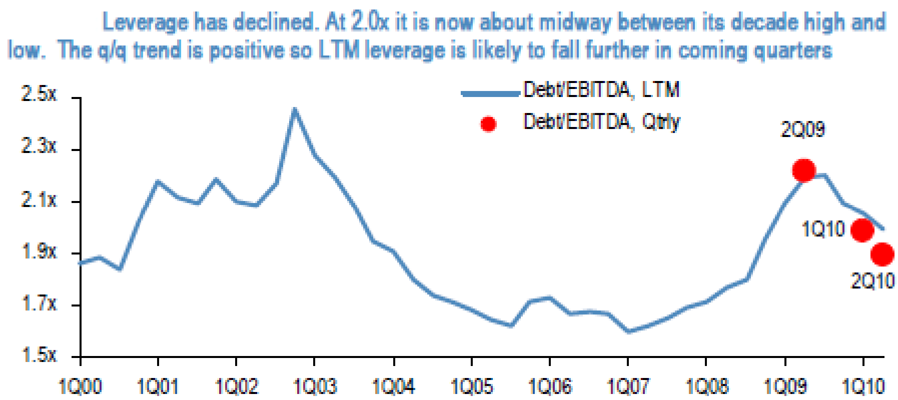
The growth in bank credit has fueled Germany's growth whereas credit has been negative on a quarterly basis in the US. However, US commercial bank credit increased (8.3% annualized) in July for only the second time in the past 21 months and

August and September continued this momentum. We do not know if this is the beginning of an upward trend in credit. If it is, then we feel more confident about our 2011 real GDP forecast of the growth rate picking up. The primary assumption underlying our forecast of faster real GDP growth is a resumption in the growth of bank credit.

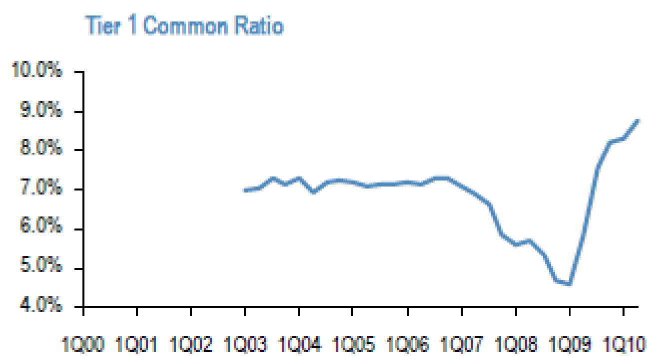
Corporate Securities

Investment grade corporate bonds returned +4.71% in the third quarter. That brings year-to-date returns to 10.77%, easily outpacing US Treasuries (8.74%), agencies (5.73%) and mortgage-backed securities (5.11%). An excess return of +1.44% in the third-quarter helped offset the negative excess return in the second quarter, and now puts corporate bond excess returns back into positive territory for the year (+0.39%).

We slightly added to our significant exposure to corporate bond securities as we continue to see value in this sector relative to other fixed income alternatives. The yield pickup of 175 basis points to Treasuries is still attractive from a historical basis, and the balance sheets of corporate issuers remain strong and liquid. Cash balances remain at decade highs and leverage continues to decline (see chart below).



Our focus on owning bonds issued by companies in the financial sector (Barclays, Bank of America, Deutsche Bank, JP Morgan, etc.) greatly benefitted the portfolios, as these were the best performing corporate securities on excess return basis. Year-to-date, financials have had an excess return of nearly 100 basis points, versus industrials at just 10 basis points. As regulators focused on making the sector safer, financial institutions continue to shrink their balance sheets and improve their capital ratios (see chart below).



These fundamentals (in addition to the significant yield pickup to other fixed income securities) have led to strong demand, particularly from retail investors, where flows out of equities and into fixed income continued in the third-quarter. Shareholder friendly activity still appears to be in its infancy, with most companies taking a cautious approach with their balance sheets heading into a still fragile economic recovery. However, we will closely monitor this development, along with any signs that investor flows may begin to shift back towards equities as the two biggest risks for corporate securities going forward.

Mortgage-Backed Securities
Mortgage-backed securities (MBS) finally started to move back towards fair value during the third-quarter. This had the effect of moving option-adjusted spreads from a miniscule 11 basis points ending the second- quarter to a current 85 basis points. With the US Treasury rally, mortgage-backed securities were still able to produce a positive absolute return of 0.63%.

During the quarter, we moved down in coupon slightly, going from Freddie Mac 30-year 5% coupon, and into Freddie Mac 15-year 4% coupons. Higher coupons reached extreme valuations on an OAS basis, and we took that as opportunity to move into lower dollar price securities. This benefitted the portfolios as higher coupons have repriced a bit cheaper, but still not enough to entice us back. That said, MBS are generally starting to look more attractive and we are researching and contemplating increasing our relatively limited exposure.

In Conclusion
We make money for our clients partly by capitalizing on market opportunities provided by investors who assume more risk than we, ourselves, think prudent. Not infrequently, these investors experience the fallout from the risks they've assumed. Their shortfalls mean that they have to sell off their *best* bonds to even stay afloat. When reasonably priced, we buy these bonds, profiting for our clients from the spread between these investors' panic and their bonds' underlying values.

To reduce worry and increase sleep, we don't go into the market each day and gobble up every good deal we can find. A bond that's good for one portfolio may not be as good for another. We try to ensure that the quality bonds we do buy are bought at a time and in a yield range when they are cheapest relative to comparable investments of similar grade.

We also use time to undertake our own credit analysis, an often lengthy process that spells the difference between a bond well had and one better left alone.

I can't tell you how many times we've been awarded an account that resembles nothing less than over-cooked spaghetti. The client can't say with any certainty where the account stands, what its true value is on any given day, or week.

Believing that you can't get there from here unless you know where here is, we spend considerable time untangling these portfolios, assessing their sometimes conflicting values, and reordering them so that their worth and future direction reads like an open book.

We also spend time communicating with our clients, in language they understand. We believe that if we can't explain an investment to an investor, then we probably don't understand it well enough to feel comfortable making it. Did I mention we don't like to worry?

In closing, sometimes, when you take a renewed look at who you are, what you do and why you do it, you recover some of the passion that got you there in the first place. And, contrary to what some might think, there is passion to fixed-income management, as there is with any job done well.