VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2010

Walking in the snow as a metaphor for fixed income management.

You know how it is. You're sitting up late one night, thinking about this and that. Family. The business. Your life. You know...this and that.

You can't sleep; don't really want to, so you decide to take a walk and shake things off.

It was such a few weeks ago when the "Blizzard of 2010" hit New York City.

Outside, cars lining the street were no more than rounded clumps of pearlescent steel. The street was glowing now and then beneath a half moon and our ever-present streetlights. Nothing was stirring, "not even a mouse." And, for a city like this one...*if* there is one...that's saying something.

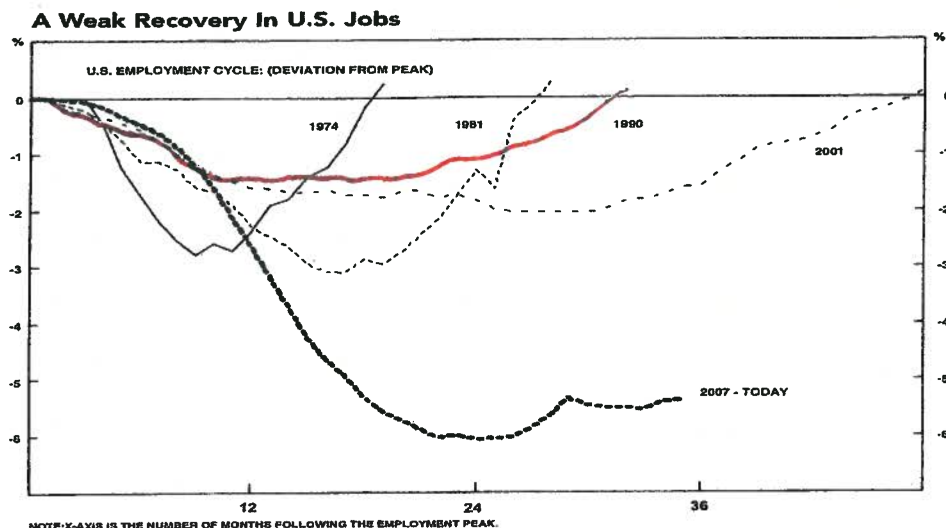
So I slapped on some boots that had seen better days, muffled and capped up, threw on an old coat and set out for nowhere in particular...this, in itself, unusual.

When I set out, I immediately sank a foot, or so it seemed. I trudged. And trudged. Dragging each foot up and out, up and out. Somehow, I managed to miss the slightly raised pavement at the corner that consistently manages to snag me on the way to work. I didn't miss the lack of noise. In fact, temporarily at least, the city was as new. No paw prints. No pigeons. No soot covered byways. No nothing but a trackless tract and an open path.

Then, I noticed something also peculiar to this night. My own tracks, behind me, appeared to be nothing more than the drag and clop of a meandering voyager on the once virgin snowscape. And, it got me thinking. But, more on this at the end of this letter, once we review the year just past.

Macroeconomic Review

Consistent with our forecast of stronger economic growth than the consensus estimate, real GDP grew 2.6% during the third quarter. The economy gained momentum and was higher than the second-quarter's 1.7%. Exports and business investment both grew and added to GDP during the quarter. Inventories also grew and added 1.6% to real GDP. The labor market remained weak, with unemployment at 9.4%, and wage gains were below the norm. During the last comparable downturn in 1980-1982, a year into that period's recovery, the economy had added more than three million jobs. Now, nearly 18 months after the recession officially ended, unemployment has fallen only 0.7%, to 9.4%. Recent declines in the unemployment rate are due to job seekers dropping out of the labor force rather than strong job growth. Bernanke said recently that it could take four-to-five more years for the job market to normalize fully. The following chart highlights the weak recovery in jobs versus other economic recoveries:



Source: Bank Credit Analyst

A healthy consumer (70% of the US economy) is the key to a sustainable recovery and is dependent upon a stronger labor market. The housing sector remains weak with a sizeable backlog of homes for sale and foreclosures remain a problem. Inflation is not a problem. There is plenty of unused capacity in the economy and the core inflation rate, which excludes food, and fuel is up 0.8% over the last 12 months. This is quite a bit less than the Fed's preferred inflation rate target of 2%. The tax cut stimulus package was approved during 2010, and its size ($858 billion over two years) rivals the size of the earlier TARP package. While the package provides additional economic stimulus over the next couple of years, serious longer-term deficit reduction measures will have to be proposed. The Federal deficit is estimated at $1.3 trillion for 2011, or approximately 9% of GDP. Deficits of this magnitude are unsustainable over the longer-term. With a favorable backdrop of continued accommodative monetary policy, additional fiscal stimulus, business investment supported by strong balance sheets in the corporate sector and exports growing at double digits, we continue to estimate 2011 GDP growth of 3%-3.5%.

Interest rates rose during the quarter and the yield curve steepened as long rates rose more than the shorter end of the curve. The following outlines US Treasury levels for the fourth-quarter:

	30-Sep	31-Dec	Change
3-monthTreasury Bills	0.15	0.12	-0.03
6-month Treasury Bills	0.19	0.18	-0.01
2-year Treasury Note	0.42	0.59	0.17
5-year Treasury Note	1.26	2.01	0.75
10-year Treasury Note	2.51	3.29	0.78
30-year Treasury Note	3.69	4.33	0.64
10-year vs. 2-year	2.09	2.70	0.61

Corporate Securities

Investment grade corporate bonds posted another year of impressive returns. Excess returns (the return earned over holding similar maturity US Treasuries) contributed 1.92% of the 8.47% total return in 2010. Bonds issued by financial corporations led this performance at 9.44%, followed by utilities (9.20%), industrials (8.65%) and non-corporate (6.36%). Strong fundamentals and a favorable technical environment helped generate high investor interest in the sector. Investors were drawn to the continued improvement in corporate balance sheets as represented by declining leverage, improved earnings, and higher cash balances. Money kept flowing into the sector as investors searched for additional yield in a low-yielding fixed income market.

Your portfolio benefitted from this performance as we maintained significant exposure to corporate bonds throughout the year and heading into 2011. Given the financial sector outperformance for the year (3.26% excess return versus next highest utilities of 1.81%), our emphasis on holding bonds from financial sector issuers such as JP Morgan, Citigroup, Goldman Sachs and GE Capital captured further value. Heading into the last couple of weeks of the year, we took some profits from the corporate bond sector in general and the financial sector in particular. Portfolios still maintain significant exposure to financials within the corporate bond allocation, but we felt it was prudent to take some profits during the year-end rally in credit spreads, in order to help put us in position to take advantage of potential new opportunities in 2011.

We are still very constructive on the corporate bond sector owing to improving fundamentals. Valuations also remain attractive on a relative basis, as option adjusted spread (OAS) to US Treasuries is still an attractive 155 basis points (bps). In addition, with the financial sector still offering more spread (191 bps) than industrials (134 bps) we will continue to seek value in this industry. That said, and taking a cue from 2010, we do not anticipate spread performance to occur in a straight line. This led to our tactical year-end reduction in corporate exposure. A number of potential risks still remain and may present opportunities to nimble investors. Rate volatility, European sovereign risk, continued financial sector reform, the emergence of more shareholder friendly/bondholder unfriendly activity and investor flows from fixed income to equities are some of the more readily identifiable. However, we anticipate that underlying strong fundamentals will prevail and reward fixed income investors for staying the course with corporate bonds.

Mortgage-Backed Securities

Mortgage-backed securities (MBS) gained 5.37% in 2010. Given the negative convexity and lower option-adjusted duration characteristics of MBS, they underperformed corporate bonds on an absolute basis. However, investors were still rewarded in their search for yield outside of the US Treasury sector. The sector's 225 bps excess returns were better than almost all other fixed income securities other than CMBS and financial corporate bonds.

In mid-December, we reduced exposure after positive performance in the sector year-to-date. Prior to December, we had moved our exposure up in coupon as higher coupon securities became more attractive with higher OAS and continued slow prepayment characteristics. Looking ahead to 2011, we anticipate reducing our exposure in a major fashion. MBS offer very little additional yield to US Treasuries and thus offer little offset to their negative convex character.

Two issues temper our enthusiasm for the sector. One, as noted above, is valuations. MBS are only slightly better yielding than the US Treasury sector, leading us to favor corporate bonds. Second is the possibility that the Home Affordability Refinance Program (HARP) will be extended and opened to those who are being denied eligibility due to origination date requirements of 3/2009 for Fannie and 5/2009 for Freddie. If HARP origination date requirements are eliminated, those who took out mortgages after these dates become eligible to refinance, and thus may push up prepayment speeds.

In conclusion
Back to the streets.

I got to thinking why my outgoing prints were as they were. It occurred to me that each drag and clop was a metaphor for my thoughts as I began my walk. Sluggish. Uninspired. Tired.

I resolved to change this pattern and so turned around and retraced those selfsame steps, but parallel to them, so I could compare their respective trails.

I raised each foot, leaving a clear depression, and planted each foot directly downward, paused a moment and drew fresh breath, really fresh and cold.

At each step, I paused and looked around again at the street I'd just covered. I thought. Took a step. Placed each foot as carefully as I could. Thought some more and was surprised not a little when, despite my slow yet steady pace, I found myself back at my doorstep, refreshed in mind and body and ready for come what may.

Behind me now lay a clear and unwavering set of incoming steps beside an outgoing set marked by lethargy and drudgery. I was ready for the New Year.

My family. My business. My life.

Walking in the snow as a metaphor for each, in turn.

Selected Yields

	Recent (12/29/10)	3 Months Ago (09/29/10)	Year Ago (12/29/09)		Recent (12/29/10)	3 Months Ago (09/29/10)	Year Ago (12/29/09)
TAXABLE							
Market Rates				**Mortgage-Backed Sec.**			
Discount Rate	0.75	0.75	0.50	GNMA 6.5%	3.08	2.01	3.72
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25	FHLMC 6.5% Gold	3.13	2.33	2.56
Prime Rate	3.25	3.25	3.25	FNMA 6.5%	2.94	2.14	2.47
30-day CP (A1/P1)	0.28	0.22	0.11	FNMA ARM	2.80	2.90	2.41
3-month LIBOR	0.30	0.29	0.25	**Corporate Bonds**			
Bank CDs				Financial (10-year) A	4.76	4.01	5.52
6-month	0.30	0.33	0.29	Industrial (25/30-year) A	5.50	4.89	5.80
1-Year	0.48	0.57	0.54	Utility (25/30-year) A	5.78	4.94	5.98
5-Year	1.55	1.68	1.97	Utility (25/30-year) Baa/BBB	6.10	5.46	6.53
U.S. Treasuries				**Foreign Bonds (10-year)**			
3-month	0.12	0.16	0.08	Canada	3.16	2.74	3.62
6-month	0.19	0.19	0.20	Germany	3.02	2.24	3.37
1-year	0.27	0.25	0.43	Japan	1.17	0.93	1.31
5-year	2.03	1.28	2.57	United Kingdom	3.57	2.91	4.08
10-year	3.35	2.50	3.80	**Preferred Stocks**			
10-year (TIPS)	1.02	0.69	1.36	Utility A	5.79	6.08	5.98
30-year	4.43	3.68	4.64	Financial A	6.48	6.52	6.82
30-year Zero	4.71	3.96	4.81	Financial Adj A	5.48	5.48	5.48