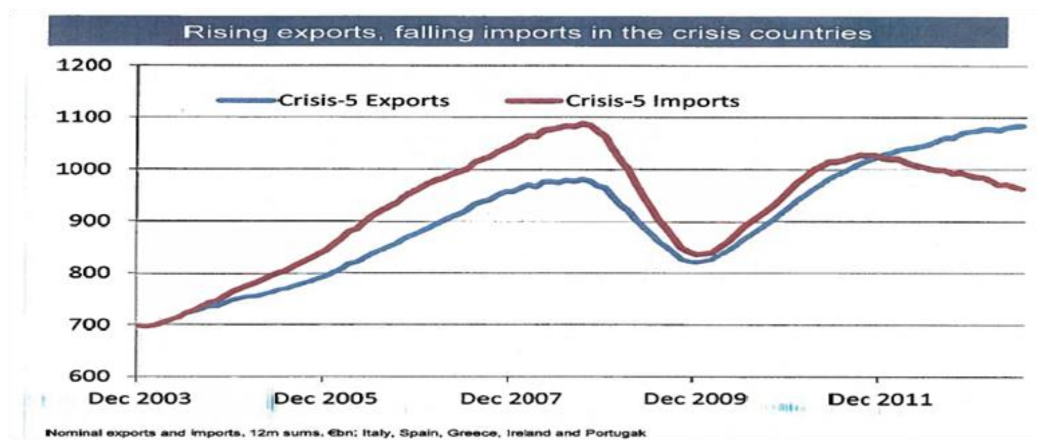
VANDERBILT Ave.
ASSET MANAGEMENT

4th Quarter 2013

Signs of improvement in the global economy should serve as a further stimulant to U.S. economic momentum. China (the world's second largest economy) is experiencing a controlled slowdown that might be beneficial for the rest of the world. China's 7.5% growth, with a stronger consumption focus, still supports world demand. In addition, there continues to be a gradual fading of the crisis in the Euro zone. The peak fiscal pain was in late-2012 and there has been a gradual easing of the austerity measures in 2013. The Southern periphery countries have experienced somewhat of a rebound. Individually, Italy, Spain, Portugal and Ireland now have a current account surplus and Greece is on track to balance its current account. Exports are 15% above pre-crisis levels (see chart below). Japan (the world's third largest economy) is receiving large monetary and fiscal stimulus through "Abenomics." If Japan is successful in reforming their labor market, the economy should experience additional strength.



Accelerating economic growth in the U.S. is lining up with our forecast of a stronger than expected expansion. Third-quarter real GDP was up 4.1% following gains of 2.5% and 1.1% for the second-quarter and first-quarter respectively. This was the strongest advance in two years and only the third time the economy had expanded that quickly from one quarter to the next since 2006. Growth was broad-based with consumer and business investment leading the way. Growth in the fourth-quarter could soften somewhat from the third-quarter as inventory investment is somewhat curtailed. Our 2014 outlook forecasts real GDP growth of 3%-3.5%. This year's growth should be aided by a continued improvement in housing and its related industries, a corporate sector with a much improved financial condition and a continued gradual improvement in the labor market which should support auto and retail sales. In addition, growth will be aided by the continued energy transformation in the U.S. In 2013 the U.S. rose to the number one energy producer (oil and natural gas) in the world thereby surpassing Russia. This was fueled by shale rock formations of oil and natural gas along with new technology (hydraulic fracturing) that was unimaginable only a decade ago.

The Federal Reserve has started a gradual tapering of their monthly bond-buying program. They reduced their monthly purchases from $85 billion to $75 billion and indicated the purchases could be completely stopped by year-end 2014. To allay market concerns, the Fed said they would hold short-term rates unchanged until at least year-end 2015. This is much more significant than the tapering of the monthly purchase program. While the economy may be growing more quickly than anticipated, low inflation indicates the economy is operating well below capacity. The inflation indicator the Fed follows most closely (personal consumption expenditures) is up only 0.9% for the 12 months ended November. Furthermore, the Fed said they will keep the fed funds rate unchanged well past the time that the unemployment rate declines below 6.5% (currently at 6.7%). The December non-farm payrolls report contained contrasting and somewhat confusing data. New jobs added (74,000) were well below the consensus estimate of 197,000. At the same time, the unemployment rate declined because the labor force participation rate continued to decline. Weather related effects probably played a role in the weak number as well as monthly upward revisions to previous data. However, it is important to point out the confidence band around these job estimates is very large. For example, for 100,000 jobs added in a given month the confidence band is in a range of 10,000 to 190,000. All of this means the Fed is much more likely to focus on the overall job market in contrast to the unemployment rate when gauging the health of the labor market.

Congress has reached a two-year budget agreement that will raise military and domestic spending by shifting across-the-board cuts from the sequester to other programs. In addition, the agreement raises various fees. This budget deal will reduce the fiscal drag from sequestration over the next year. Fiscal expenditures will increase by $45 billion in 2014 and by another $20 billion for the fiscal year 2015. The most important aspect of the agreement is that it removes the uncertainty that has been associated with fiscal policy for the past three years. This uncertainty had given the private sector reason for pause before committing capital for investment thereby hampering growth during the recovery.

During the fourth-quarter, the yield curve experienced a “bear steepener” as rates rose more for the long-end of the curve versus the short-end. Interest rate levels at the end of the quarter were as follows:

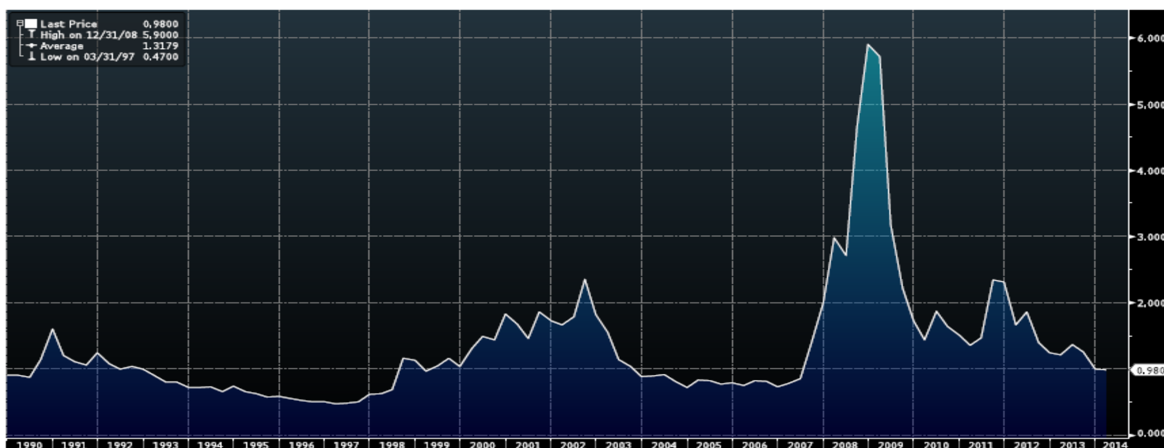
	30-Sep	31-Dec	Change
3-monthTreasury Bills	0.01	0.07	0.06
6-month Treasury Bills	0.03	0.09	0.06
2-year Treasury Note	0.32	0.38	0.06
5-year Treasury Note	1.38	1.74	0.36
10-year Treasury Note	2.61	3.03	0.42
30-year Treasury Bond	3.69	3.97	0.28
10-year vs. 2-year	229	265	36

Corporate securities

The corporate bond market was the best performing sector of the investment grade fixed income market during 2013. Our exposure to the sector was the key component to performance. The sector combined higher income and spread tightening to provide strong relative performance versus U.S. Treasuries. Option Adjusted Spreads ("OAS") ended the year at approximately 25 basis points tighter from the prior year-end for both 1-3 year maturity and intermediate corporate bonds. Excess returns versus comparable U.S. Treasuries were 2.26% for intermediate maturities and 1.55% for 1-3 year maturity corporate bonds. Corporate bond spreads are now at levels last reached in the third-quarter of 2007, prior to the 2008 financial crisis. Earlier that year, spreads reached a low .70% over Treasuries.

Bloomberg

J6OAS Index (Barclays Intermediate Corporate Average OAS)



Financial companies ended the year as the best performing sector within corporates, while the industrial sector lagged the overall corporate market but easily outperformed risk-free U.S. Treasury securities. Financial sector returns were strong across each of the sub-sectors including banks, brokerage and insurance. Within the industrial segment, metals, cable, and wireless telecom companies underperformed for the year. These sectors did rebound in the 4th-quarter as their spreads tightened significantly. Consistent financial fundamentals and a reasonable economic growth outlook drove the performance of the corporate bond market. Our portfolios continue to have an overweight to the sector at the start of the New Year.

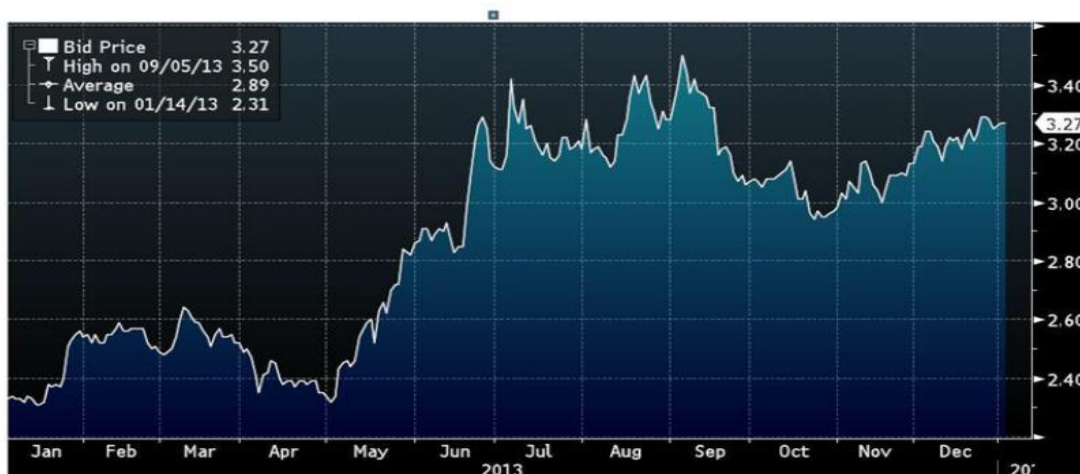
The financial foundation of corporate bond issuers remains solid. 76% of S&P 500 companies reported earnings in line with or better than market expectations, an improvement over the second quarter. In addition, reported sales and earnings growth

also exceeded market expectations by over 70%. Corporations have taken full advantage of low interest rates to reposition their balance sheets over the past two years with record bond issuance of approximately $1.1 trillion each year. Even though a portion of proceeds have been utilized to increase dividends and/or stock buybacks, the low absolute financing costs will be less costly than prior issuance. In addition, our BAML Lighthouse quantitative screen points toward further spread tightening for the sector as spreads are still 26 basis points cheap to fair value. Financial company outperformance was based on the ongoing improvement in fundamentals and the settlement of various legacy mortgage and legal issues for the largest banks. For instance, the annualized loan loss provision for the largest 25 U.S. banks was just 0.28% in the third quarter as compared to 4.24% for the same quarter in 2009. Capital ratios have stabilized at relatively high levels (i.e. 11.1% Tier 1 Common Capital Ratio), and nonperforming assets are relatively modest as compared to equity plus reserves at just 8.5%. Bank of America, Goldman Sachs and Morgan Stanley were several strong performers held by our portfolios during the past year. Since financial OASs tightened by approximately 0.37% for 1-3 year securities and 0.48% for intermediate bonds, the sector is now trading in line with the overall corporate bond market. Financial sector returns in 2014 are unlikely to repeat their strong outperformance.

New positions to your portfolio in the fourth-quarter included Devon Energy (Baa1/BBB+), an independent exploration and production oil and gas company. The company had EBITDA/Interest coverage of 12.4 times and just 1.05 times Net Debt/EBITDA in the last quarter. Their earnings surprise was positive and the investment has modest upside as it trades 17 basis points cheap to fair value based on our quantitative screen. The investment was made at the time of a new issue by the company. Cameron International (Baa1/BBB+), an energy exploration service company, was also purchased. The company has strong cash flow and the investment was made at the time of their new issues to extend their short-term borrowing. EBITDA/Interest coverage was a solid 15.9 times and Net Debt/EBITDA was just 0.26 times. Earnings were not significantly different from analyst expectations in the last quarter. In the consumer retail sector, Starbucks (Baa1/A-) was purchased when they issued bonds. Starbucks has limited debt, strong interest and debt coverage, and no short-term debt as of the end of the last quarter. Their earnings surprise was significantly positive for the last quarter. The company should provide consistent performance over a wide range of economic conditions. A final example is Dominion Resources (Baa2/A-). The utility has strong EBITDA/Interest coverage of 6.4 times for utility companies, a significantly positive earnings surprise in the last quarter, and is trading approximately 16 basis points to fair value. Their stable utility earnings should provide support to the bonds through the full economic cycle.

Mortgage-Backed Securities

Mortgage-Backed Securities (MBS) outperformed comparable U.S. Treasuries during the fourth quarter. MBS yields have crept wider since late October, ending the quarter up twenty basis points. While the Federal Reserve's December policy statement announced the beginning of tapering in January, its otherwise cautious tone prevented a more pronounced widening in yields from occurring.



We continued to decrease our exposure to MBS during the fourth-quarter in anticipation of higher rates. Currently, the MBS allocation within your portfolio represents only a modest exposure to this asset class. Our portfolios include both FNMA & FHLMC securities.

Despite the resilience shown by the MBS market immediately following the Fed's announcement, we still believe that tapering will put pressure on the mortgage market in the coming months. Accordingly, we will maintain our cautious stance on MBS, until such a time as the yields and OAS offered by these products appropriately compensate for their inherent risk.

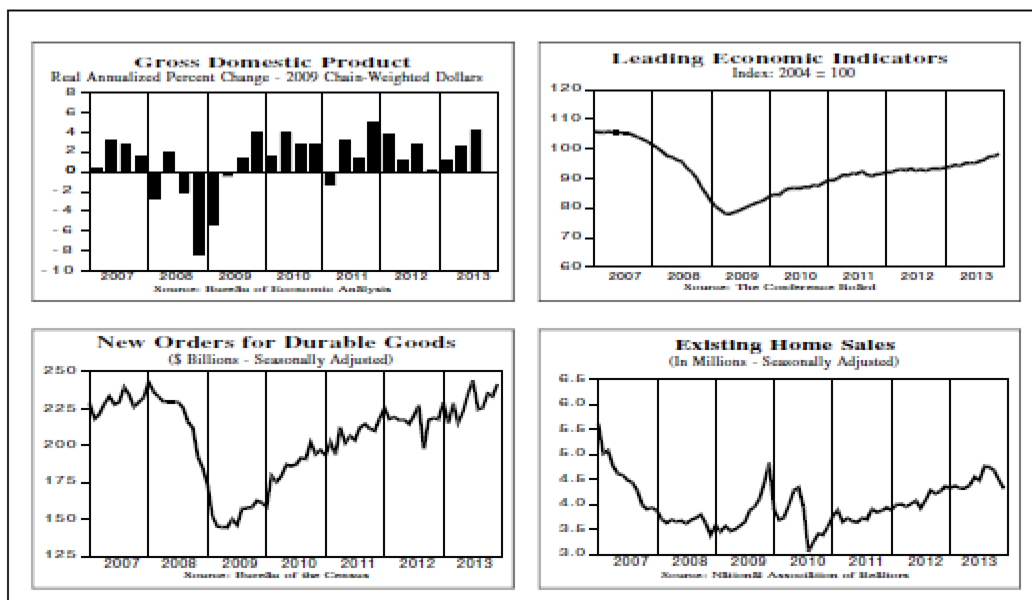
The Treasury Markets Practice Group (TMPG) of the Federal Reserve has recommended that certain forward-settling MBS, including TBA investments, have margin requirements. While our accounts currently do not contain TBA investments, we are reviewing the proposed requirements and discussing the potential impact of these changes on our mortgage investment strategy.

Asset-backed Securities

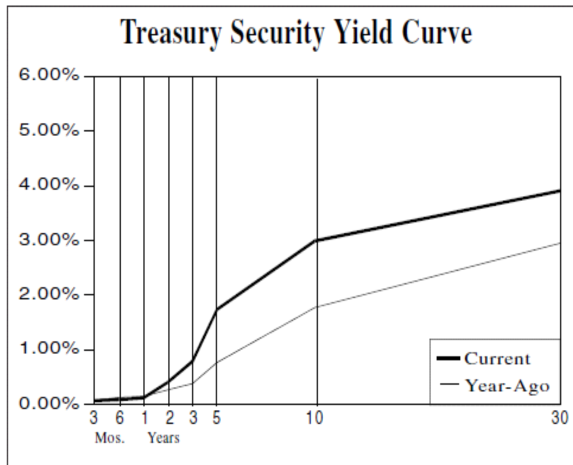
Asset-backed Securities (ABS) also outperformed comparable U.S. Treasuries during the fourth-quarter. The ABS included in our portfolios are high quality (i.e. AAA rated), stable, liquid securities. They include credit card receivables, auto loan receivables and dealer floor plan financing, as well as equipment leasing transactions. We use these securities as a cash substitute, with relatively attractive yields versus Treasury and Agency bonds.

Several new ABS positions were added during the third-quarter. Two examples of deals which were added to our portfolios are: 1) Capital One Multi-Asset Execution Trust 2013-A3 (Cap One Bank servicer / BONY trustee) & 2) CNH Equipment Trust 2013-D A3 (New Holland Credit Co. servicer / Deutsche Bank trustee). These deals typify the types of ABS deals we prefer, with AAA ratings and very high quality collateral.

Tracking the Economy



	Recent (12/24/13)	3 Months Ago (9/25/13)	Year Ago (12/26/12)		Recent (12/24/13)	3 Months Ago (9/25/13)	Year Ago (12/26/12)
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	0.75	0.75	0.75	GNMA 5.5%	2.18	2.36	1.79
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25	FHLMC 5.5% (Gold)	2.20	2.56	2.16
Prime Rate	3.25	3.25	3.25	FHLMC 5.5%	2.00	2.32	1.82
30-day CP (A1/P1)	0.10	0.12	0.24	FHLMC ARM	2.12	2.11	2.17
3-month Libor	0.25	0.25	0.31	**Corporate Bonds**			
Bank CD's				Financial (10-year) A	4.24	4.07	3.06
6-month	0.07	0.07	0.10	Industrial (25/30-year) A	4.76	4.69	3.86
1-year	0.09	0.09	0.13	Utility (25/30-year) A	4.68	4.57	3.92
5-year	0.53	0.58	0.70	Utility (25/30-year) Baa/BBB	5.06	5.19	4.24
U.S. Treasury Securities				**Foreign Bonds**			
3-month	0.07	0.02	0.08	Canada	2.72	2.57	1.82
6-month	0.09	0.05	0.13	Germany	1.89	1.82	1.37
1-year	0.12	0.10	0.15	Japan	0.70	0.67	0.79
5-year	1.74	1.43	0.77	United Kingdom	2.98	2.75	1.89
10-year	2.99	2.64	1.77	**Preferred Stocks**			
10-year (inflation-protected)	0.77	0.43	-0.78	Utility A	6.15	6.14	5.54
30-year	3.91	3.68	2.95	Financial A	6.55	6.49	6.20
30-year Zero	4.15	3.94	3.16	Financial Adjustable A	5.47	5.47	5.47



Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	12/11/13	**11/27/13**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	2440755	2395156	45599	2325519	2188872	1928799
Borrowed Reserves	168	173	-5	222	281	393
Net Free/Borrowed Reserves	2440587	2394983	45604	2325297	2188591	1928407

MONEY SUPPLY

(One-Week Period; in Billions, Not Seasonally Adjusted)

	Recent Levels			Ann'l Growth Rates Over the Last...		
	12/09/13	**12/02/13**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	2626.5	2613.1	13.4	10.6%	6.3%	8.4%
M2 (M1+savings+small time deposits)	10954.3	10934.4	19.9	6.4%	7.1%	6.0%

Source: Unites States Federal Reserve Bank