VANDERBILT Ave. ASSET MANAGEMENT

4th Quarter 2016

There were several elements to VAAM's 2016 economic outlook that proved correct that we would like to briefly review due to their positive implications for 2017. The Federal Reserve's move to interest rate normalization was in gradual steps and in small increments as we envisioned. While we thought that China would experience a slowdown in their economic growth rate, we did not foresee an implosion of their economy as many had forecasted. Contrast to the consensus, we felt that the U.S. economy would gain momentum and inflation would strengthen as 2016 progressed. In the wake of this economic momentum, we thought that corporate earnings would be solid and reaccelerate. This led us to maintain the overweight allocation to corporate fixed income securities which provided positive relative investment performance for the year.

The economy experienced stronger economic growth during the third quarter and consensus forecasts for 2017 have been raised. VAAM continues to forecast real GDP growth above consensus estimates. We look for 2017 growth to be in a 3%-3½% range. The economy grew at a 3.5% annualized rate in the third quarter and was led by the consumer sector (approximately two-thirds of overall GDP). This growth rate represented the fastest pace in two years. Consumer spending is being aided by an improving labor market that should continue to provide a tailwind to the economy. The jobless rate (4.7%) is near the lowest level in nine years. The U.S. has added 15 million jobs since the labor market bottomed out in 2010. Business investment spending, which has not been strong, should catch up with increased economic momentum. The uncertainty of the election is over with and corporate tax reform and incentives combined with a multi year infrastructure program should support increased capital investment. Furthermore, regulatory relief should also incentivize capital investment. Wage gains are outpacing inflation. Average hourly earnings jumped by 2.9% in the 12 months through December, the most since the last recession ended in June 2009 and well above the 2% average that prevailed during much of the expansion. The repatriation of overseas profits as part of tax simplification should provide incremental funds for cap expenditure budgets. In addition, spending by the government sector will grow. For the first time in recent years, there is a real possibility of significant changes in fiscal policy. The Trump administration's fiscal stimulus policy will be comprised of both personal and corporate tax reform and lower rates along with increased spending for both the defense sector as well as the infrastructure program. There is a consensus that infrastructure investment has lagged, there are numerous projects that are viable candidates and the budget deficit has some room to grow after several years of austerity. The approximate one trillion dollar multi year infrastructure program should be aided by the ability to finance at today's relatively low interest rates. Fiscal stimulus should create a virtuous circle of spending boosts that leads to new investment and hiring which prompts further spending. VAAM's growth estimate for 2017, if anything, could turn out to be on the low side.

Monetary policy should continue to ensure a continued low interest rate environment. Even though the Federal Reserve is beginning to raise the fed funds rate to reflect the strength in the labor market, recent upticks in inflation and increased economic momentum, they have said the course of interest rate increases should continue to be at a gradual pace. As they have stated in the past, the formulation of monetary policy will be data dependent as the economy evolves. The Fed recently raised the fed funds rate by a ¼% to a 0.5%-0.75% range-just the second increase in the past decade. They cited the uncertainty regarding the specifics of Trump's economic policies along with the strength of the U.S. dollar. A strengthening dollar will act as a headwind to exports and cause overseas earnings to be worth less in in USD terms. However, exports should not serve as a major drag on GDP growth because they are a much smaller percentage of the U.S. economy vis-à-vis some other global economies. One danger to monitor is that the Fed gets behind the inflation curve. Inflation is gaining momentum and is closer to the Fed's goal of 2% annualized gain for the core PCE. Core personal consumption expenditures excludes food and fuel and is the Fed's preferred gauge of inflation. Recent core PCE rates have risen at a 1.7% annualized rate. Higher inflation is a reflection of a tighter labor market as well as increasing health care costs. Rising costs for medical services such as doctors, hospitals and health insurance is a reversal in a trend that saw cost increases for these services slowing in recent years. Core PCE has a 20% weighting in healthcare versus a 7% weighting within CPI.

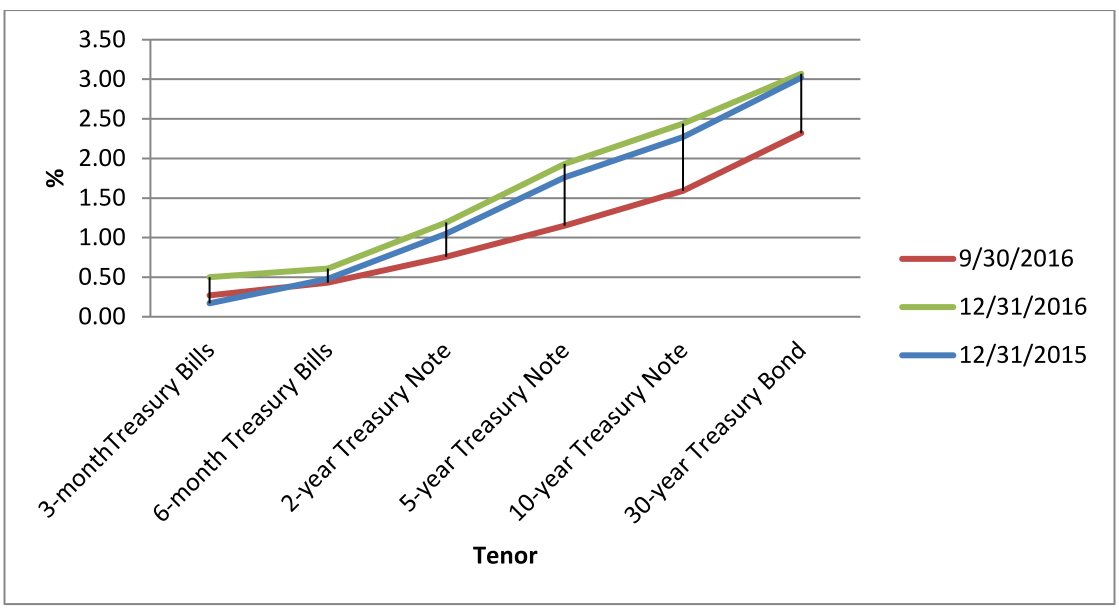
Uncertainties revolve around the exit of the U.K. from the Euro union and the future of the euro zone, trade policy and various geopolitical concerns. Another uncertainty is the larger fiscal deficits vis-à-vis the Republican Congress. Mr. Trump's promises will test congressional Republicans' commitment, frequently voiced during the Obama years, to rein in deficits. Productivity remains in a growth slump. From 1994-2003, productivity (output per hour) rose at an annual rate of 2.8%. Since then it has grown at only a 1.3% rate. The productivity slowdown is one of the root causes of the slow growth of the economy since the recession. An infrastructure program offers the potential of aiding productivity. All these uncertainties will lead to strong bouts of volatility during 2017.

The yield curve steepened and shifted upwards during the 4th quarter. However, relative to the beginning of the year, the curve flattened very slightly and exhibited a slight upward shift. Expectations of higher growth and inflation, coupled with a tightening of monetary policy, drove yields higher by the end of the quarter. The 10- year yield increased by 85 basis points relative to the 3rd quarter and 17 basis points vis-à-vis the start of the year. The majority of the increase was experienced in the latter months of the year, as the post-election environment reignited volatility in rates with the promise of accelerated growth driven by fiscal expansion.

The spread between the 10-year and the 2-year Treasury notes widen 42 basis points, from the previous quarter end, to 125 basis points. On a year over year basis, the spread remained approximately unchanged with a widening of 3bps. The table below shows the yield curve at the end of the fourth quarter 2015, third quarter 2016 and fourth quarter 2016.

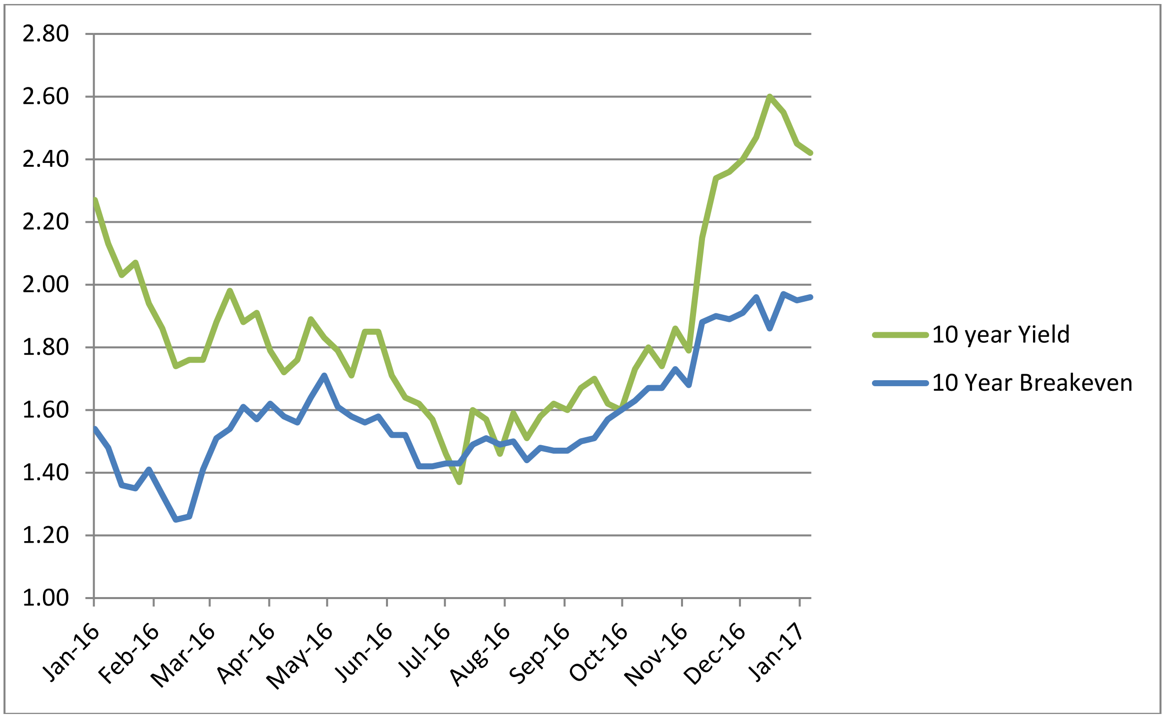
	12/31/2015	9/30/2016	12/31/2016	Change(Q/Q)	Change(Y/Y)
3-month Treasury Bills	0.17	0.27	0.50	0.23	0.33
6-month Treasury Bills	0.48	0.43	0.61	0.18	0.13
2-year Treasury Note	1.05	0.76	1.19	0.43	0.14
5-year Treasury Note	1.76	1.15	1.93	0.78	0.17
10-year Treasury Note	2.27	1.59	2.44	0.85	0.17
30-year Treasury Bond	3.02	2.32	3.07	0.75	0.05
10-year vs. 2-year	122	83	125	42	3

The curve shifted upward by an average of 54 basis points. Effectively, the curve returned to levels similar to those seen the end of last year. The shift was concentrated in the short-to-intermediate end of the curve, with significant movement in the short-end resulting from tighter monetary policy. The rise in yields is consistent with the narrative of higher economic growth, driven by fiscal expansion, and higher inflation expectations. Moreover, the Fed's promise of three rate hikes over the course of 2017 is also putting upward pressure on yields.



Select US Treasury Yields Source: Bloomberg

The 4th quarter was characterized by increased volatility and rising yields, as market participants weigh a more expansionary fiscal policy, an increased outlook for inflation and a tighter monetary policy. This is further reflected in the rise of the 10 year yield, which increased dramatically over the quarter. Decomposing the yield into a real rate and an inflation expectations component further supports the idea that the recent rise is primarily driven by an increase in expectations for future growth. This is noticeable in the graph below, which demonstrates that rise in yields has been accompanied by an increase in inflation expectations as measured by the spread between the 10 year U.S. Treasury issue and 10 year inflation protected securities. Accordingly, inflation expectations have been hovering near 2% for the majority of the fourth quarter, a significant increase from the 1.5% seen at the start of the year.



Source: Federal Reserve Economic Data

Corporate Securities

The corporate bond market ended the year on a high note. Investor optimism for U.S. and global growth potential in 2017 drove spread compression for bonds in the Merrill Lynch 1-10 Corporate Index .06% during the quarter and 0.37% for the full year versus comparable duration U.S. Treasury securities. Spreads during the fourth quarter actually widened by a modest 0.01% for Merrill Lynch 1-3 Year Corporate Index after tightening by over 0.20% in the prior three quarters. The price change from the move in spreads coupled with the higher income of the corporate sector provided strong relative performance across the yield curve for both the quarter and the full year. For instance, the Merrill Lynch 1-3 Year Corporate Index enjoyed 0.25% of excess returns during the fourth quarter and 1.42% for the full year while the Merrill Lynch 1-10 Corporate Index outperformed by 0.68% and 3.00%. Our portfolios benefited from this corporate outperformance due to the overweight allocation maintained throughout the year.

Our position in the sector, in addition to a growing economy, is based on a number of factors. Despite 2016 strong performance of corporate bonds, spreads remain fairly valued in light of our economic forecast. The current average spread of the overall corporate market stands at 1.30% based on the Barclays Corporate Index and 0.88% for the Merrill Lynch 1-3 Year Corporate Index, which compares to the tightest spread since 1997 of 0.51% and 0.39% respectively. Caution is warranted, however, since the median spread from the beginning of 1997 has been 1.30% and 0.94% respectively. The BAML Lighthouse Quantitative model (which incorporates equity prices, equity volatility, and level of debt to calculate a fair value of individual company's debt and compares this risk spread to the company's CDS to provide an excess spread estimate) was at the lower end of fair value at 0.21% at the end of the third quarter. During the fourth quarter, even after incorporating the higher equity prices from the year end equity rally, the model projects a lower 0.18% excess spread for the overall U.S. corporate bond market.

78% of S&P companies reported earnings that met or exceeded market expectations. This number is on the high side for most quarters. During the past several quarters, financial fundamentals of investment grade issuers have weakened from a strong position earlier in the recovery. Financial fundamentals based on data from Morgan Stanley research continues to show gradual but persistent deterioration. Gross debt leverage stands at 2.38x and net leverage is at 1.85x. Gross leverage has now risen for six straight quarters and net leverage has risen faster than gross leverage for the past two years. Both stand above recent highs of past recoveries. This increase in leverage is being driven by debt growth, up 11% YOY while LTM EBITDA was down 4%, flat ex-energy. The increase in investment grade leverage is broad based with well over 50% of companies having done so. The EBITDA to Interest Expense ratio has been strong throughout the recovery as the rising debt levels were offset by the significantly lower interest rates on that new debt. At its peak during this cycle, the ratio was near 12 times but due to rising debt levels and lower growth rate in EBITDA it has fallen to 10.25x. Down significantly from its peak but only modestly below its peak in the prior economic expansion. We remain overweight the sector, though our performance may be limited to the higher interest income provided by these bonds.

During the last quarter several positions were added to our portfolios. As an example, Dominion Resources was purchased. The public utility had a positive earnings surprise in the last quarter, interest coverage of just under six times and provides approximately 17 basis points of excess return based on the BAML Lighthouse model. These financial fundamentals are reasonable for this stable, cash flow generating company. Also added was Maxim Integrated Products. The company designs and manufactures a range of integrated circuits as well as design processes that is used in custom designs. The company had a positive earnings surprise during the last quarter, interest coverage a strong 25.5x, gross leverage of just 1.7x and a strong cash position that more than covers all outstanding debt. Looking forward, our overweight to this sector will be focused on companies in relatively stable industries, a history of strong cash flow and reasonable leverage.

Asset Backed Securities

In similar fashion to the first three quarters, short ABS posted another round of strong returns in the fourth quarter. While total return was just -0.02%, excess return over similar duration U.S. Treasury issues was 0.202% for the quarter, bringing the annual excess return to 1.03% over Treasuries. In an environment of interest rate uncertainty, this solid performance can be attributed to stable prepayments accompanied with low delinquency rates.

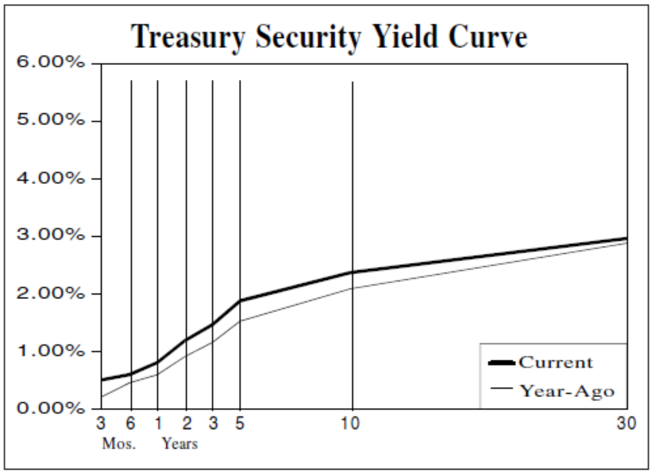
Our portfolios remains overweight in ABS. We continue to invest in only the highest quality AAA rated ABS, collateralized by credit card receivables, auto loans/leases and equipment loans. We invest in prime auto loan securities, which offer lower yields, but significantly better credit stability than sub-prime loans. The short ABS securities will continue to post low delinquency rates each month.

Additionally, the ABS in our portfolios offer stable cash flows with either locked out prepayment windows or gradual prepayments that do not fluctuate with interest rate movements. We buy both short fixed rate and floating rate securities. This combination leads to stable returns when interest rates rise and fall.

In the fourth quarter, we added several ABS, including credit card and auto. We purchased a two-year average life floating rate credit card security: Bank of America Credit Card Trust 14-A1 A, backed by Bank of America credit card receivables. This security is locked out from prepayments for two years and its coupon floats with changes in 1-month labor, insulating it from rising rates. Additionally, we invested in a 1.5 year average life fixed rate security: Mercedes Benz Auto Lease Trust 2016-B A3, backed by leases on Mercedes Benz vehicles. The loans backing this security are of extremely high quality, with an average FICO score of 784 and 60 day delinquency of only 0.03%.

Selected Yields

	Recent (1/11/17)	3 Months Ago (10/12/16)	Year Ago (1/13/16)		Recent (1/11/17)	3 Months Ago (10/12/16)	Year Ago (1/13/16)
TAXABLE							
Market Rates				**Mortgage-Backed Securities**			
Discount Rate	1.25	1.00	1.00	GNMA 5.5%	2.19	1.16	2.10
Federal Funds	0.50-0.75	0.25-0.50	0.25-0.50	FHLMC 5.5% (Gold)	2.40	1.43	2.26
Prime Rate	3.75	0.40	3.50	FHLMC 5.5%	2.23	1.34	1.93
30-day CP (A1/P1)	0.66	0.88	0.37	FHLMC ARM	1.76	1.86	1.80
3-month Libor	1.02	0.66	0.62	**Corporate Bonds**			
U.S. Treasury Securities				Financial (10-year) A	3.56	3.05	3.52
3-month	0.51	0.34	0.22	Industrial (25/30-year) A	4.05	3.75	4.16
6-month	0.60	0.47	0.46	Utility (25/30-year) A	4.08	3.85	4.24
1-year	0.81	0.68	0.60	Utility (25/30-year) Baa/BBB	4.50	4.28	4.78
5-year	1.88	1.29	1.53	**Foreign Bonds**			
10-year	2.37	1.77	2.09	Canada	1.68	1.20	1.24
10-year (inflation-protected)	0.38	0.12	0.73	Germany	0.33	0.07	0.57
30-year	2.96	2.50	2.88	Japan	0.07	-0.06	0.20
30-year Zero	3.04	2.59	3.02	United Kingdom	1.35	0.82	1.74
				Preferred Stocks			
				Utility A	5.94	5.36	6.03
				Financial A	5.94	5.82	5.95
				Financial Adjustable A	5.49	5.49	5.49



Source: Value Line, Inc.

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	01/04/17	**12/21/16**	**Change**	**12 Wks.**	**26 Wks.**	**52 Wks.**
Excess Reserves	1789629	1979295	-189666	1973718	2089954	2197187
Borrowed Reserves	49	33	16	70	137	103
Net Free/Borrowed Reserves	1789580	1979262	-189682	1973648	2089817	2197084

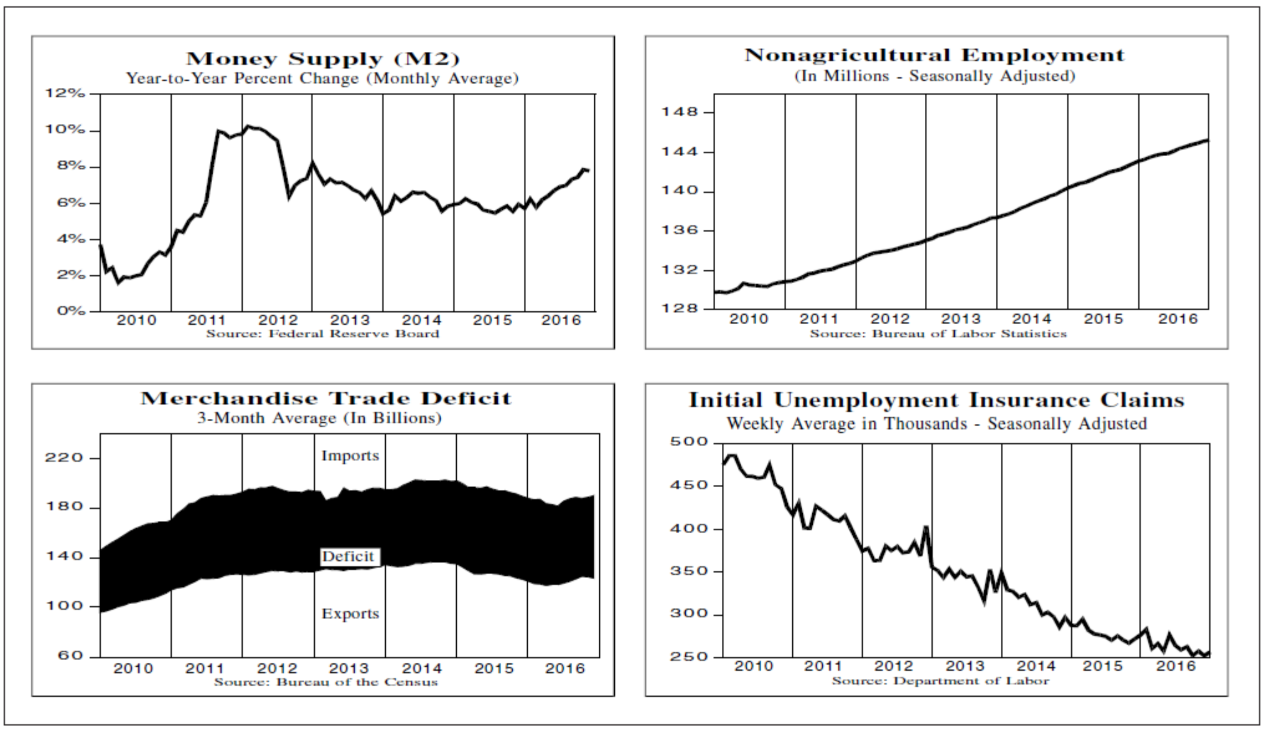
MONEY SUPPLY

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

	Recent Levels			Ann'l Growth Rates Over the Last...		
	12/26/16	**12/19/16**	**Change**	**3 Mos.**	**6 Mos.**	**12 Mos.**
M1 (Currency+demand deposits)	3324.3	3333.3	-8.9	2.2%	6.2%	8.2%
M2 (M1+savings+small time deposits)	13260.4	13236.1	24.3	5.3%	6.6%	7.5%

Source: Unites States Federal Reserve Bank

Tracking the Economy



Source: Value Line, Inc.