VANDERBILT Ave.
ASSET MANAGEMENT

1st Quarter 2011

Let's see, how to describe the first quarter of this year?

Tumultuous! Nah. Too tame.

Effervescent! Uh-uh. Too bubbly.

No, we'll just have to settle on calling it (tongue firmly in cheek) the quarter of the "The Mad Mouse."

I've heard from friends of mine (at least, those who grew up in the proverbial backwoods) about their childhoods and the dizzying glory they felt when the carnival came to town. It might have been a state fair, or a Barnum wannabe, or maybe just one of those dwindling breed of independent operators who arrived by truck or train to set up shop in local fields.

Invariably, my friends would describe one sunny day (every day at the carnival was sunny) when a troupe of marvelous and majestic players strutted under the Big Top, or headlined the venues that squatted beside it. Along with the usual assortment of five legged cows and candied treats, it seems, they often brought with them a most unusual attraction known as "The Mad Mouse."

The Mad Mouse was not so much a ride, they'd say, as an adventure in terror. Not a roller coaster. Not a Ferris wheel. But something more, something designed for the sole purpose of making you leave your lunch behind.

You and one or two brave friends would sit in a box that resembled nothing less than an ore cart, the kind you might see rumbling out of silver mines in old westerns. Then, without warning, you would be off, careening two-wheeled around right angle turns, falling through precipitous dips and dives, stopping abruptly at the defining line between air and airborne and otherwise getting the thrill (or nightmare) of your young lives.

Yep, that's it then. The first quarter was the bond market equivalent of the Mad Mouse. More on this later.

Macroeconomic Review

Fourth-quarter 2010 GDP grew at an annual rate of 3.1% (the full-year grew 2.9%). Growth was lead by the consumer (70% of GDP) at 4.0%. This was an increase from the consumer growth rate of 2.9% in the third-quarter. Final demand for the quarter (excluding inventories) grew 6.7%-the most since 1998. Positives for the quarter included exports and business investment in addition to the consumer. A gradually improving job market brought the unemployment rate down to 8.8% from a 10.1% peak. Unemployment is not expected to decline significantly anytime soon. Wage growth remains static and the recovery in the labor market is very weak relative to previous recoveries. Headwinds to the economic outlook include a continued weak housing market, deleveraging at both the household and business levels, abating fiscal stimulus and a 40% oil price increase since September. Inflation is not an imminent problem despite commodity price increases due to the economic slack in the economy and strong growth in labor productivity. Lenders remain cautious and have not transformed their increased liquidity from the Fed's QE2 stimulus program into new loans and investments. The 2011 estimated budget deficit of $1.5 trillion at 9.8% of GDP is the second largest since World War II (behind the 10% level of 2009). Fed Chairman Bernanke has said the Federal deficit is the nation's greatest long-term problem. He has encouraged lawmakers to come up with a long-term plan to address the deficit while at the same time maintaining fiscal stimulus until the economy and the labor market are on a firmer footing. Higher economic growth could play a major role in solving the deficit/debt levels. For example, the Congressional Budget Office expects the economy to grow 2.8% on average over the next decade. If GDP instead grew 1.1% faster during that period, matching the Fed's estimate for this year, the annual budget deficit would nearly disappear. The debt-to-GDP ratio would dip to 55% by 2021, lower than it is today. Whereas last year we forecast robust economic growth greater than consensus in the 3%-3.5% range, we now believe growth will slow to approximately 2.5% which is less than the consensus forecast. The primary reasons for this include cutbacks in Federal spending in order to address the budget deficit, larger than estimated reductions in state/local spending in order to address their difficult fiscal situation, the lack of the housing sector providing its usual cyclical boost to an economic recovery and the continued soft labor market impact upon consumer spending.

At their March 15 meeting, the Fed reiterated the economy was improving but would continue measures to stimulate growth because it remained more concerned about unemployment than the risk of increased inflation. The Fed affirmed its plan to purchase $600 billion of US Treasury securities by the end of June and left unchanged its two-year old commitment to hold the fed funds rate in a 0%-1/4% range for an "extended period." Their statement reflected greater optimism about the economy; however, recovering from a recession is not the same thing as the economy being in good health. The Fed is still not convinced the economy will continue to grow without federal support. They said the recent surge in oil and other commodity prices is likely to subside without causing a rise in prices of a broader range of goods and services. The rate of pass-through from commodity prices to broad indexes of US consumer prices has been quite low in recent decades, partly reflecting the relatively small weight of materials inputs in total production as well as the stability of longer-term inflation expectations. Therefore, higher commodity prices are likely to translate into temporary and relatively modest gains in consumer prices.

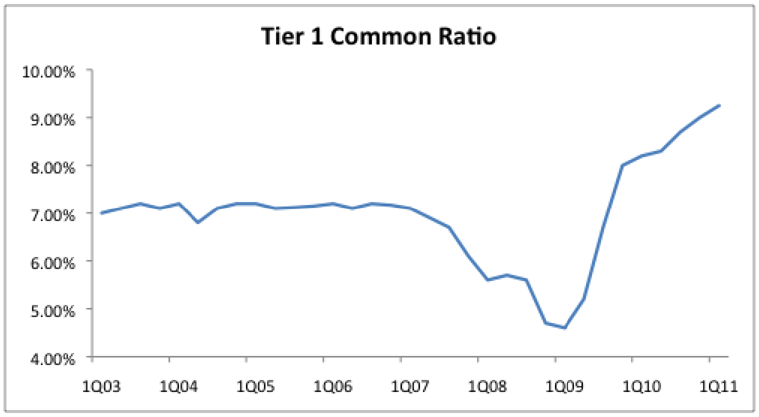
Interest rates rose during the quarter and the yield curve was slightly flatter as two-seven year maturities increased a little more than the 10-30 year sector of the curve. The following outlines US Treasury levels for the first-quarter:

	31-Dec	31-Mar	Change
3-monthTreasury Bills	0.12	0.09	-0.03
6-month Treasury Bills	0.18	0.17	-0.01
2-year Treasury Note	0.59	0.82	0.23
5-year Treasury Note	2.01	2.28	0.27
10-year Treasury Note	3.29	3.47	0.18
30-year Treasury Note	4.33	4.51	0.18
10-year vs. 2-year	2.70	2.65	-0.05

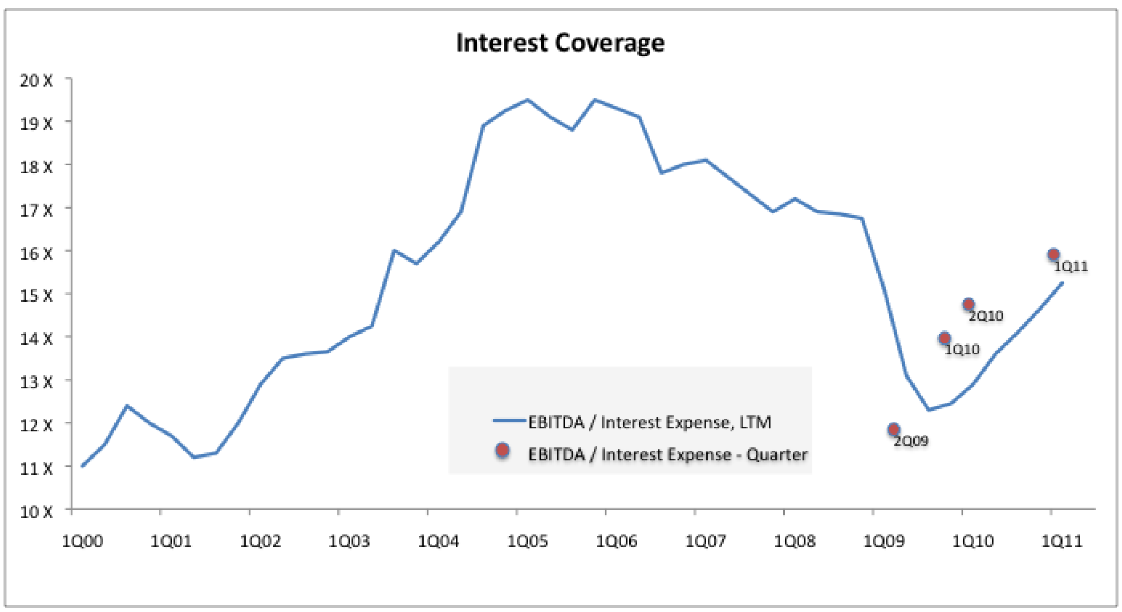
Corporate Securities

The corporate sector provided positive excess returns versus similar maturity US Treasuries. Performance was led by financial institutions followed by utilities and then industrials. Despite the strong gains that have been experienced over the past few quarters in corporate bonds, we remain significantly overweight this sector. This is due to a number of factors.

Corporations overall are in the best shape that we have seen in over a decade. Corporate balance sheets are characterized by higher cash balances, improved earnings and cash flows, and reduced leverage. First-quarter upside earnings surprises (i.e. where actual reported earnings exceed average analyst estimates) have been coming in at roughly 67%. Global economic growth will continue to provide fuel for further corporate earnings improvement.



Bank financial strength continues to improve. Tier 1 common ratios for U.S. banks have risen above 9% (vs. low of 4%-5% for Q1 2009). Industrial leverage remains low; Debt/EBITDA has declined to approximately 1.7x from its recent high of 2.1x in Q2 2009. Interest coverage has risen to 17x from its recent low of 12x in 2009, as EBITDA increased vs. stable debt levels.



U.S. corporate issuance set a first quarter record, at approximately $250 billion, as companies continued to capitalize on seemingly inexhaustible investor demand. We believe that issuance will remain healthy through the remainder of 2011, as corporations look to refinance and extend maturities.

Investment grade corporate yields remained range-bound during the first-quarter, averaging 142 basis points over US Treasuries. This still represents a significant opportunity in our opinion, as historical spreads have averaged closer to +120 basis points (i.e. the impact of a 22 basis point tightening on a 5-year bond position would represent an approximate +1% price return over and beyond coupon income). There will be additional spread volatility in the coming months, primarily due to increased M&A activity, continued southern European sovereign debt concerns, as well as geopolitical events in Africa and the

Middle East. However, we do believe that the longer-term trend is still positive, and will continue to seek out the most attractive relative value opportunities within the corporate sector.

Mortgage-Backed Securities

The mortgage-backed security ("MBS") sector returned 0.58% during the first-quarter. MBS provided positive excess returns of 55 basis points. As far as agency allocation, Ginnie Mae's and Freddie Mac's have outperformed Fannie Mae's by 8 and 9 basis points respectively. The option-adjusted spread ("OAS") for fixed rate MBS started off the quarter at 42 basis points and ended the quarter tightening to 33 basis points. During the quarter, OAS traded in a range between 33 basis points on March 31st and 46 basis points on February 9th.

We maintained the portfolio's Ginnie Mae 5% position until mid March. As OAS widened through the month of March we added to the Ginnie Mae position at these wider levels. At the same time that our Ginnie Mae position was increased we also added a position in the Freddie Mac 4.5% coupon.

We believe the MBS sector to be relatively fair valued at these levels and in a stable rate environment their inherent negative convexity is less of a concern. One piece of information of note concerns the US Treasury winding down their MBS portfolio. With this wind down there will be more MBS supply in the market, however robust demand should be able to absorb this added supply in the near-term.

In Conclusion

Even given the colorful hyperbole of our introduction, I'd have to allow that the first quarter was not that much different than many other quarters gone before.

A new House sat. The Fed sat still. A new war, or conflict, or whatever got underway, or paused, or finished, depending on whom you asked. The economy was either moribund or recovering and people talked, as they always seem to, about doom and gloom or explosive expectations…again, depending on whom you asked. Armageddon and optimism balanced one another and the world moved on.

As usual, bonds reacted…up, down and sideways…to these developments and others, and those of us who manage bonds for a living took them in stride.

We straightened the right angles and smoothed the dips and dives. We imposed order where there appeared to be none and put a rope on the mad mice of the day.

And, you know what? After so many years of doing this, after so many carnivals, all of us here love it as if it were our first, just as we appreciate our clients who have come along with us for the ride.

Our thanks. May all our days ahead be sunny.