VANDERBILT Ave.
ASSET MANAGEMENT

2nd Quarter 2013

VAAM's economic forecast continues to be for economic growth faster than the consensus outlook and gaining momentum as the year progresses. After 1.8% real GDP growth in the first-quarter, we forecast growth will approximate 3.0% by the fourth-quarter of the year. The consumer sector (approximately two-thirds of overall GDP) was up 2.6% for the quarter and provided the greatest contribution to overall growth. Business investment spending, for equipment and software as well as structures, will add to growth. Manufacturer's capital goods shipments increased 6.1% over the last three months. Housing and car sales remain a big plus for the economy. The latest home price measure, the S & P/Case-Shiller Home Price Index, increased by 12.1% year-over-year in April. This is the biggest year-over-year gain since March 2006. Low mortgage rates continue to benefit the housing market. June auto sales were the strongest in six years-rising 9.2% versus one-year ago.

At their recently concluded June meeting, the Federal Reserve said they could start winding down their bond buying program later this year and end it altogether in mid-2014. They have a more optimistic forecast than previously with unemployment declining to a 6.5%-6.8% range by the end of 2014. Bernanke said the wind-down of the bond buying program (i.e. slowing the amount of assets purchased) could begin later this year if growth picks up, unemployment goes down and inflation moves closer to the 2% target. Inflation remains low as the rise in the core PCE deflator at 1.3% remains comfortably below any flash point for the Federal Reserve. The employment cost index indicated that total compensation is still modest further supporting a low inflation outlook. Low inflation intimates that the Fed will retain its current policy of large-scale asset purchases. Fed policy will remain flexible as it assesses the economy's health. It is important to recognize that monetary policy is changing gradually as the bond buying program is the first step. Raising short-term interest rates from near zero is not likely until much later. The fixed income market's reaction has not focused on the subtle elements of Fed policy-i.e. the principal component of Fed policy is that the fed funds rate will be kept near zero. Absent a run up in inflation, it says it won't raise its target on overnight rates until unemployment falls below at least 6.5%. Its own projections suggest that probably won't happen until 2015. Curtailment of asset purchases by the Fed will occur only if there is stronger economic data. If this happens, the stronger fundamentals should help the corporate sector and we would anticipate yield spreads narrowing from current levels. Some uncertainty was raised when President Obama, referring to Fed Chairman Bernanke, indicated that he may not be inclined to dissuade the Fed chairman from stepping down when his term ends in January.

During the quarter, the yield curve steepened as long rates rose more than the shorter end of the market. The following outlines interest rate changes for the first-quarter:

	31-Mar	30-Jun	Change
3-monthTreasury Bills	0.07	0.03	-0.04
6-month Treasury Bills	0.10	0.09	-0.01
2-year Treasury Note	0.24	0.36	0.12
5-year Treasury Note	0.76	1.40	0.64
10-year Treasury Note	1.85	2.49	0.64
30-year Treasury Note	3.10	3.50	0.40
10-year vs. 2-year	161	213	52

Corporate Securities

The trend in the corporate bond market continued during April and May with the sector outperforming similar duration U.S. Treasury securities. At the end of May, the OAS (option adjusted spread) of the broad investment grade credit market was 1.25%, the average since 1990. A litany of worries hit the market in June led by concern of a slowdown in the Euro zone, China and Brazil, and a change in Federal Reserve policy. All risk assets came under pressure including investment grade corporate bonds. Spreads in investment grade bonds reversed quickly in June as the average option adjusted spread widened by 0.19% to 1.44% at month-end. Excess returns during the month were -1.30% and moved the Credit Index excess return negative for the full year. The impact was more muted on the short-

end of the yield curve as corporate bonds underperformed comparable Treasury bonds by approximately 0.25% during June. The overweight to the sector in our portfolios had a negative impact on performance during the past month. Industrials were the worst performing area of the market followed by the utilities and financials.

Our portfolio holdings in the sector are based on solid financial fundamentals. 73% of S&P 500 companies reported better than expected earnings for the first-quarter of the year. Debt levels have increased modestly from their lowest levels as issuance at low absolute interest rates has been used for stock buybacks and dividend increases. Net leverage (Total Debt-Cash/LTM EBITDA) remains relatively low at 2.01 times. Our quantitative screen, which incorporates equity prices, volatility and debt levels to predict a fair value for a company's debt, remains positive. In light of increasing volatility of equity prices and near term uncertainty of Federal Reserve policy, corporate spreads are likely to remain volatile. We continue to believe, however, that over the coming months corporate bonds will provide attractive returns for our portfolios and we expect to add modestly to the sector. For instance, at the end of the quarter, Trans-Canada Pipelines was purchased. The company is the premier natural gas pipeline company in Canada and has relatively stable financial fundamentals and is trading cheap to its calculated credit risk.

As mentioned above, the industrial sector was the worst performing sector within the corporate market with the metals and mining subsector led the underperformance. Last quarter we mentioned Freeport McMoran as an attractive investment opportunity. Our investment process continues to support holding the bond. Cash flow remained strong through the first quarter of the year with EBITDA/Interest Coverage at 22.4 times and Total Debt/ EBITDA of 1.53x. First quarter earnings surprised on the upside and the bonds provide significant excess spread with a yield or 1.69% and a maturity in just 1.6 years as of quarter-end. The sector will be more volatile than the overall market as it is sensitive to global growth expectations. On the positive side, financial companies provided modest excess returns during the first-half of the year. Brokerage and insurance companies led the way. Morgan Stanley and Goldman Sachs are significant holdings. Both have continued to improve their capital ratios and benefit from their leadership in investment banking. Positive earnings and wide spreads make them attractive long term investments.

Mortgage-Backed Securities
Mortgage-Backed Securities (MBS) underperformed similar duration U.S. Treasuries during the second quarter. Despite the Federal Reserve's continued accommodative policies, interest rates rose during the quarter, adversely impacting MBS performance. MBS yields increased 50-60 basis points on average during the quarter-as depicted in the chart.

LUMSYW Index (Barclays US MBS Index Yield To Worst)

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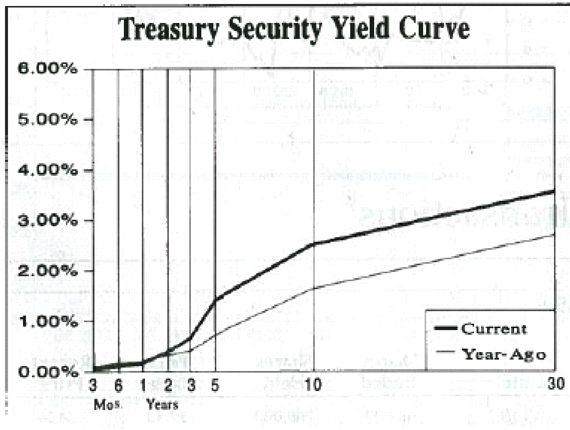
We significantly decreased the exposure to MBS during the second quarter, as the potential for even higher rates has outweighed the benefits of this asset class. Our portfolios include both FNMA & FHLMC securities of 15- & 30- year

maturities. We continue to favor 15-year maturities due to their shorter durations, relatively stable prepayments and more predictable cash flows, given a wide range of potential interest rate scenarios.

While Chairman Bernanke reiterated the Fed's intent to maintain its accommodative policies at least until its inflation and unemployment targets are met, the market has begun to anticipate a tapering off of some kind in the coming few quarters. Accordingly, we will maintain a cautious stance on MBS until such time as the yields and OAS offered by these products appropriately compensate for their risk.

	Recent (6/26/13)	*3 Months Ago (3/27/13)*	*Year Ago (6/27/13)*
TAXABLE			
Market Rates			
Discount Rate	0.75	0.75	0.75
Federal Funds	0.00-0.25	0.00-0.25	0.00-0.25
Prime Rate	3.25	3.25	3.25
30-day CP (A1/P1)	0.17	0.20	0.33
3-month Libor	0.28	0.28	0.46
Bank CD's			
6-month	0.08	0.10	0.20
1-year	0.10	0.13	0.32
5-year	0.64	0.70	1.10
U.S. Treasury Securities			
3-month	0.05	0.08	0.09
6-month	0.10	0.11	0.16
1-year	0.16	0.12	0.20
5-year	1.40	0.77	0.72
10-year	2.49	1.86	1.62
10-year (inflation-protected)	0.55	-0.67	-0.49
30-year	3.55	3.10	2.69
30-year Zero	3.80	3.36	2.89



Source: Value Line, Inc.

	Recent (6/26/13)	*3 Months Ago (3/27/13)*	*Year Ago (6/27/13)*
Mortgage-Backed Securities			
GNMA 5.5%	2.42	1.93	1.42
FHLMC 5.5% (Gold)	2.87	2.32	1.93
FHLMC 5.5%	2.58	1.80	1.84
FHLMC ARM	2.13	2.12	2.29
Corporate Bonds			
Financial (10-year) A	3.98	2.96	3.32
Industrial (25/30-year) A	4.68	4.06	3.93
Utility (25/30-year) A	4.59	4.07	3.87
Utility (25/30-year) Baa/BBB	4.98	4.40	4.31
Foreign Bonds			
Canada	2.50	1.76	1.72
Germany	1.77	1.27	1.57
Japan	0.87	0.52	0.81
United Kingdom	2.46	1.72	1.69
Preferred Stocks			
Utility A	5.92	5.51	5.28
Financial A	6.21	5.93	6.41
Financial Adjustable A	5.48	5.47	5.47
TAX-EXEMPT			
Bond Buyer Indexes			
20-Year Bond Index (Gos)	4.37	3.99	3.95
25-Bond Index (Revs)	4.81	4.37	4.72
General Obligation Bonds (Gos)			
1-year Aaa	0.27	0.17	0.22
1-year A	0.95	0.82	0.92
5-year Aaa	1.60	0.89	0.86
5-year A	2.47	1.85	1.92
10-year Aaa	3.00	2.13	2.06
10-year A	3.94	3.03	3.13
25/30-year Aaa	4.13	3.22	3.56
25/30-year A	5.82	4.93	4.88
Revenue Bonds (Revs) (25/30-Year)			
Education AA	5.11	4.24	4.35
Electric AA	5.21	4.37	4.66
Housing AA	5.60	4.72	4.75
Hospital AA	5.17	4.55	4.58
Toll Road Aaa	4.87	4.49	4.41