3rd Quarter 2013

Wall Street was consumed with two topics as the third quarter came to an end. The animus between the Republican and Democratic parties was in clear view and raised concerns over both a Federal government shut-down and a possibility of no increase in the debt level, raising the specter of a U.S. Treasury default. The second was the longer running debate over when the Federal Reserve would begin to "taper" their purchases of Treasury bonds and Agency Mortgage-Backed securities. The dysfunctional Federal government lack of action is likely to have an outsized impact on the financial markets over the first half of the fourth quarter.

In the near term, the uncertainty between the Administration and Congress regarding the budget for 2014 and raising the debt ceiling has the greatest potential to adversely impact economic growth and U.S. investment markets. The government shutdown was a harbinger of the fight over the debt ceiling. The bigger risk to the economy and markets is the prospect that a protracted fight over the shutdown leads lawmakers into an impasse over how to raise the government's borrowing limit. Without an increase in the debt ceiling, the government could run out of funds to pay all its bills, which could cause severe financial turmoil. On October 10th, the Republican controlled House of Representatives announced a compromise to increase the debt ceiling for six weeks to provide time for negotiations to begin with the President. The government shutdown was not included in that compromise and, as a result, this proposal was not accepted. As the debt level approaches, the Senate Republicans and Democrats are attempting to reach a compromise that will reopen the government and expand the debt limit into the early part of 2014. We think the ramifications from failing to raise the debt ceiling are so serious that there is a high probability of resolving this issue prior to a debt level created default.

At their recently concluded September meeting, the Federal Reserve surprised most market participants by electing to maintain the pace of their stimulus programs. The Fed said they were too optimistic in their previous economic outlook and would, therefore, continue the current purchase program of U.S. Treasury securities and Agency mortgage-backed securities at the same pace. In addition, they said they would keep short-term rates near zero well after the unemployment rate is under 6.5% (currently 7.3%). Their concerns revolve around a continued weak labor market, inflation well below their target level, a GDP growth rate not at a high enough sustainable level and fiscal drag from the sequester impact. October 9th, President Obama nominated Dr. Janet Yellen to be the next Federal Reserve Chairman. Dr. Yellen is expected to be pragmatic, and flexible based on her past monetary policy statements. For instance during her tenure as Federal Reserve Governor in the 1990's, she was supportive of tightening monetary policy despite relatively high unemployment due to then labor conditions that could have led to higher inflation. As President of the San Francisco Fed., she supported the increase in the Fed Funds rate to maintain price stability from 2004 through 2007. In light of ongoing weakness in the labor market, however, the Federal Reserve's current stimulus programs are likely be continued under a Yellen Chairman.

Economic statistics released during the third-quarter were mixed. Interest rate sensitive sectors such as housing and auto sales benefited from historically low interest rates. Other statistics, however, were less robust and growth remains below the level necessary to achieve sustainable improvements in the labor market. VAAM continues to forecast that economic momentum will pick up beyond consensus forecasts. Reasons for this stronger outlook include the following:

- the housing market is entering a powerful multi-year upswing that will have a positive multiplier effect on appliances, furniture, plumbing, electrical and other goods; U.S. home prices rose by their fastest pace in more than seven years in July and are up 12.4% from a year earlier;
- the oil and gas sector revival has positive implications for growth, jobs, trade and capital flows, unconventional oil and gas drilling (fracking) currently supports more than 1.7 million jobs in the U.S. and this number will nearly double by the end of the decade, in addition, the U.S. will become energy independent, furthermore; the U.S. is overtaking Russia as the world's largest producer of oil and natural gas;

- consumer spending (70% of GDP) has the potential to lead a recovery as household balance sheets have been repaired; households spent only 10.5% of after tax income on debt payments earlier this year which represents the smallest portion since 1980; the recoveries in the stock market and housing sector have also improved household balance sheets;
- the banking industry recovery has led to cleaned up balance sheets, increased bank lending to business, a profit recovery and the resumption of dividend payments;
- the U.S. remains a leader in technology as 29% of global R&D spending was in the U.S. (twice that of China), the patent rate is near an all time high and U.S. universities are at the top of world rankings;
- the budget deficit has improved significantly with an estimated 2013 deficit of $642 billion, down from the 2012 level of $1.087 trillion; this represents 4% of GDP, down from 7% in 2012.

Inflation does not appear to be a problem for the foreseeable future. It is well below the Fed's 2% target (1.2% for the 12 months through August excluding food and energy). The utilization rate is below 82%, and with unit labor costs under control, it does not appear that labor costs will be an issue. In addition, health care inflation is moderating-this has historically been a major driver of the deficit and a burden for both businesses and households.

During the third-quarter the longer end of the yield curve experienced an interest rate increase while the shorter end of the curve had a modest decline in rates, thus resulting in a "bear steepener" move for the quarter. The following outlines the U.S. Treasury yield curve:

	30-Jun	30-Sep	Change
3-monthTreasury Bills	0.03%	0.01%	-0.02%
6-month Treasury Bills	0.09	0.03	-0.06
2-year Treasury Note	0.36	0.32	-0.04
5-year Treasury Note	1.40	1.38	-0.02
10-year Treasury Note	2.49	2.61	0.12
30-year Treasury Note	3.50	3.69	0.19
10-year vs. 2-year	213	229	16

Corporate Securities

A weak ending to the second-quarter was quickly reversed in July as relative returns fully offset the prior month underperformance. Year-to-date, the market has provided modestly positive excess returns of 0.24% versus comparable U.S. Treasury issues. The higher income of the sector has been the sole source of outperformance as corporate spreads have widened from an average of 1.31% at the beginning of the year to 1.35% at the end of September. Shorter maturity bonds, as measured by the BofA Merrill Lynch 1-3 Year Corporate Index, have provided consistent outperformance this year as only June's return did not match comparable U.S. Treasuries. Excess returns are approaching 1.00% at the end of the third- quarter. During the past quarter, U.S. financial bonds had the best relative performance, while industrials enjoyed a modest bounce but remains the weakest segment for the year. Within the industrial segment, basic industry had the best performance as metal company spreads tightened by 0.28%; however, they are still almost 0.50% wider from the beginning of the year. Both financial and basic industrials performance was driven by an improved outlook for global growth during the third-quarter.

The financial fundamentals of corporate issuers are not showing any serious signs of deterioration. For instance, 71% of S&P 500 companies had better than expected earnings for the second-quarter. This result is consistent with that last several quarters though at the lower end. Cash flow and net leverage remain at reasonable levels though leverage has increased this year due to low absolute interest rates for new debt issues and an increase in dividends and stock buybacks. BAML Lighthouse, our quantitative screen, indicate that current market spreads provide an estimated 0.32% of excess spread over the 0.65% of calculated credit risk. These support our ongoing significant exposure to the sector, which we expect to maintain through year-end.

During the past quarter, several new names were added to our portfolios. For example, AbbVie Inc., a spin-off from Abbott Labs, is a pharmaceutical company that produces specialty drugs. The company has strong cash flow and a significant cash position. Key financial ratios are supportive of their Baa1/A ratings. These include earnings before interest and depreciation ("EBITDA")/interest ratio of over 20 times and net debt to EBITDA of just 1.3 times. Cash easily covers their outstanding short-term debt and short-term debt as compared to long-term debt is very low (2.5%). Their earnings surprise last quarter was positive. AbbVie's financial fundamentals easily pass our investment screens. Another investment was Halliburton Co. which provides energy services, engineering and construction services. Rated A2/A, Halliburton has historically enjoyed relatively stable operating results. EBITDA/interest ratio was over 20 times and net debt to EBITDA was just 0.6 times in the third-quarter. The company has no short- term debt. A positive earnings surprise also supports the investment. Halliburton's debt provides a modest pick-up to Lighthouses' calculated risk. Their spreads, however, should experience relatively low volatility in light of their stable operating results and strong fundamentals. A new issue of Enbridge Inc., Baa1/A-, was also purchased. Enbridge transports and stores crude oil and natural gas liquids. Their pipeline operations provide stable cash flow and, like the utility industry, they are able to carry higher debt levels than industrial companies with comparable ratings. For instance, their long-term debt to total capital is 50% and they had an EBITDA to interest ratio of 4.0 times. Their earnings were not significantly different from analyst estimates last quarter. The investment provides an attractive yield of 0.65% over LIBOR and since its coupon is floating, this investment provides protection against a rise in interest rates.

Mortgage-Backed Securities

Mortgage-Backed Securities (MBS) outperformed comparable U.S. Treasuries during the third quarter. The Federal Reserve's most recent policy statement took the market by surprise, with no tapering of either U.S. Treasury or MBS bond purchases. MBS yields, which had been at near-term highs prior to the announcement, dropped sharply (as shown in the graph) ending the quarter down five basis points.

We continued to decrease you exposure to MBS during the third quarter in anticipation of higher rates. The MBS allocation within our portfolios now stands at its lowest level in years. Our portfolios includes 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 the Fed did not taper its bond purchases at the September meeting, we believe that a tapering of some kind will be announced in the coming few quarters, which will begin to put pressure on the mortgage market. Accordingly, we will maintain a cautious stance on MBS, until such a time as the yields and OAS offered by these products appropriately compensate for their inherent risk. We continue to monitor global economic and political developments which may impact the U.S. MBS market, and we continue to maintain the best relative value MBS positions in our portfolios.

Asset-Backed Securities

Asset-Backed Securities (ABS) outperformed comparable U.S. Treasuries during the third quarter. The ABS included in our portfolios is high quality (i.e. AAA rated), stable and has very good liquidity. 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 U.S. Treasury and Agency issues.

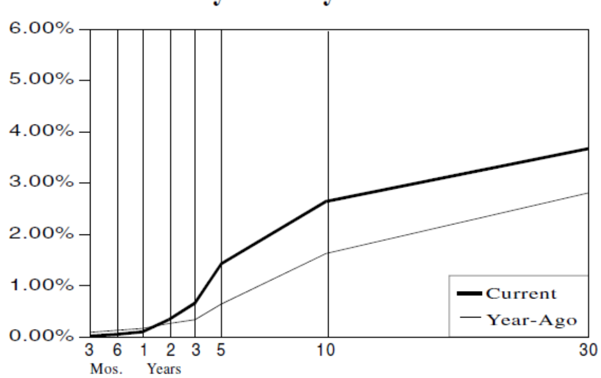
Several new ABS positions were added to our portfolios during the third quarter, primarily in the credit card space. One example is the Golden Credit Card Trust 2013-1A (RBC servicer / CIBC trustee). This deal is typical of the types of credit card ABS deals we prefer. It carries AAA ratings, and its collateral is of very high quality (i.e. low charge-offs and delinquencies).

Selected Yields

	Recent (9/25/13)	3 Months Ago (6/26/13)	Year Ago (9/26/12)
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)	0.12	0.17	0.26
3-month LIBOR	0.25	0.28	0.36
Bank CDs			
6-month	0.07	0.08	0.13
1-year	0.09	0.10	0.17
5-year	0.58	0.64	0.86
U.S. Treasury Securities			
3-month	0.02	0.05	0.09
6-month	0.05	0.10	0.13
1-year	0.10	0.16	0.17
5-year	1.43	1.40	0.64
10-year	2.64	2.49	1.63
10-year (inflation-protected)	0.43	0.55	-0.81
30-year	3.68	3.55	2.81
30-year Zero	3.94	3.80	2.99

	Recent (9/25/13)	3 Months Ago (6/26/13)	Year Ago (9/26/12)
Mortgage-Backed Securities			
GNMA 5.5%	2.36	2.42	0.65
FHLMC 5.5% (Gold)	2.56	2.87	1.93
FNMA 5.5%	2.32	2.58	1.64
FNMA ARM	2.11	2.13	2.25
Corporate Bonds			
Financial (10-year) A	4.07	3.98	2.98
Industrial (25/30-year) A	4.69	4.68	3.68
Utility (25/30-year) A	4.57	4.59	3.82
Utility (25/30-year) Baa/BBB	5.19	4.98	4.16
Foreign Bonds (10-Year)			
Canada	2.57	2.50	1.75
Germany	1.82	1.77	1.46
Japan	0.67	0.87	0.78
United Kingdom	2.75	2.46	1.69
Preferred Stocks			
Utility A	4.77	5.92	5.08
Financial BBB	6.49	6.21	5.93
Financial Adjustable A	5.47	5.48	5.47

Treasury Security Yield Curve



	Recent (9/25/13)	3 Months Ago (6/26/13)	Year Ago (9/26/12)
TAX-EXEMPT			
Bond Buyer Indexes			
20-Bond Index (GOs)	4.66	4.37	3.72
25-Bond Index (Revs)	5.24	4.81	4.37
General Obligation Bonds (GOs)			
1-year Aaa	0.18	0.27	0.20
1-year A	0.83	0.95	0.78
5-year Aaa	1.41	1.60	0.76
5-year A	2.21	2.47	1.74
10-year Aaa	2.91	3.00	1.98
10-year A	3.75	3.94	3.10
25/30-year Aaa	4.26	4.13	3.34
25/30-year A	5.88	5.82	4.81
Revenue Bonds (Revs) (25/30-Year)			
Education AA	5.12	5.11	4.25
Electric AA	5.20	5.21	4.36
Housing AA	5.58	5.60	4.70
Hospital AA	5.23	5.17	4.45
Toll Road Aaa	5.03	4.87	4.30

Source: Bloomberg Finance L.P.

Federal Reserve Data

BANK RESERVES

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

	Recent Levels			Average Levels Over the Last...		
	9/18/13	9/4/13	Change	12 Wks.	26 Wks.	52 Wks.
Excess Reserves	2218436	2173670	44766	2088676	1948125	1723202
Borrowed Reserves	280	274	6	332	363	667
Net Free/Borrowed Reserves	2218156	2173396	44760	2088343	1947762	1722535

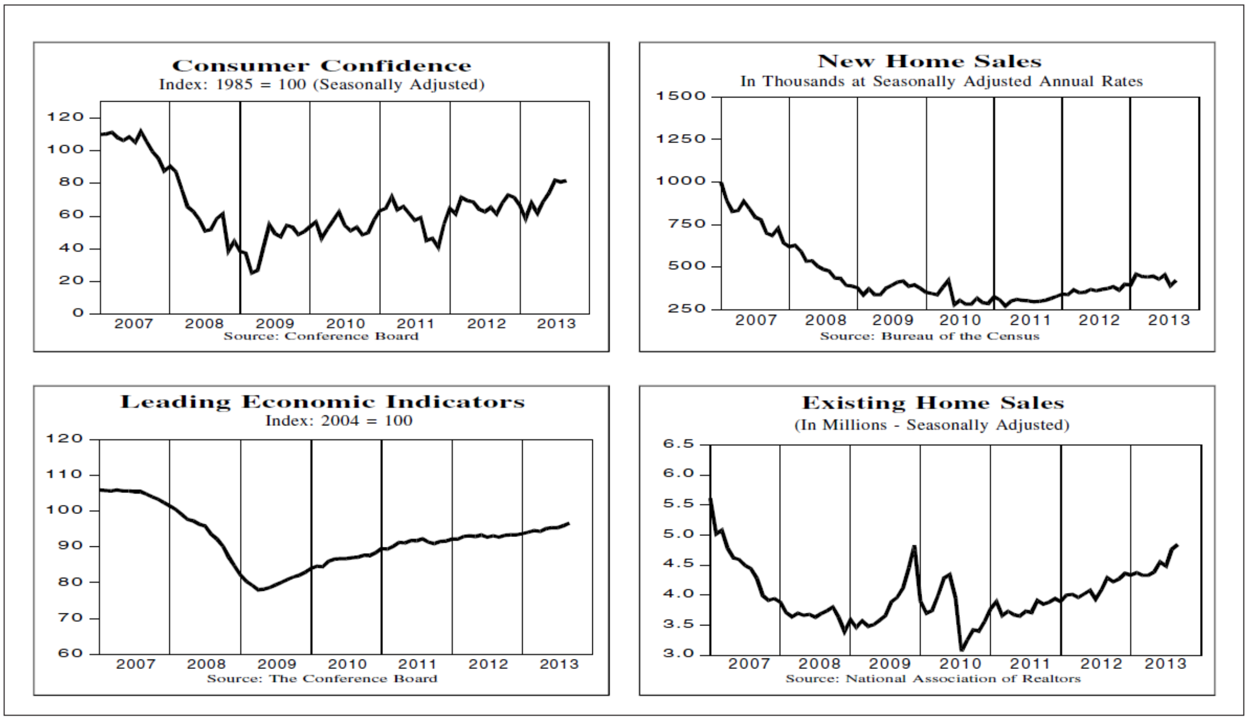
MONEY SUPPLY

(One-Week Period; in Billions, Seasonally Adjusted)

	Recent Levels			Ann'l Growth Rates Over the Last...		
	9/9/13	9/2/13	Change	3 Mos.	6 Mos.	12 Mos.
M1 (Currency+demand deposits)	2559.1	2554.9	4.2	2.0%	8.2%	8.2%
M2 (M1+savings+small time deposits)	10789.6	10789.9	-0.3	7.7%	7.1%	6.5%

Source: United States Federal Reserve Bank

Tracking the Economy



Source: Value Line Publishing LLC