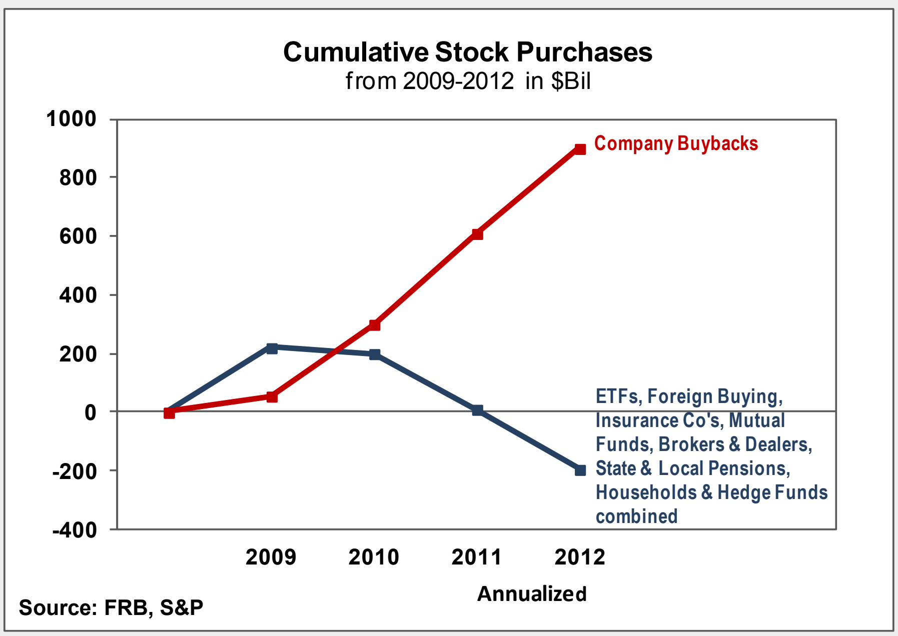
fourth quarter 2012

INVESTMENT. perspective

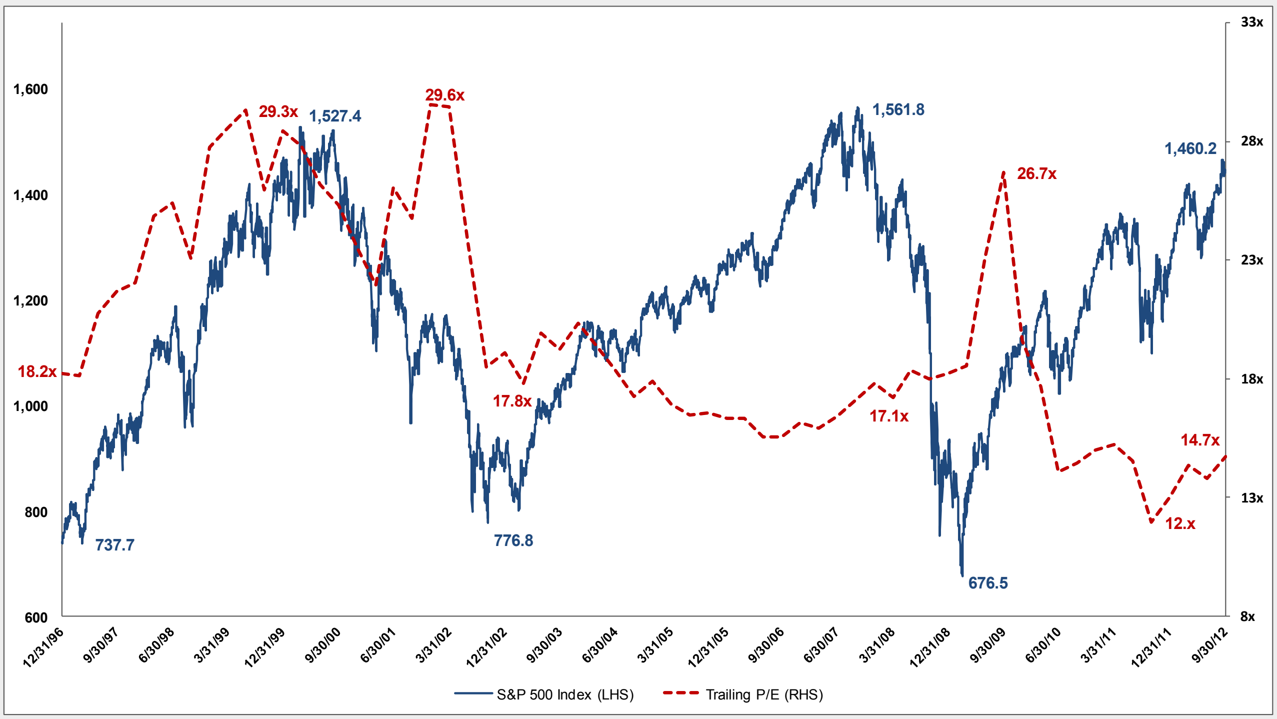
Global and domestic macro economic factors dominated the investment landscape in 2012. Throughout the year, investors were confronted with the ongoing euro zone crisis, the so called “fiscal cliff” in the United States, as well as an election with perceived major policy implications. At the same time, corporations continued to manage amidst both uncertainty and a tepid economic recovery. The Federal Reserve remained highly accommodative as did central banks around the world. In all, investors saw positive returns in both the equity and bond markets with the S&P 500 returning 16.0% while the Barclays Aggregate Bond Index returned 4.2% for the year.

As we enter 2013 we expect market volatility to remain elevated as the tug of war between fundamentals and liquidity continues. The maturing business cycle and the unintended consequences of legislative policy implementation will continue to challenge top line growth and increase margin pressure through the first two to three quarters of 2013. Offsetting these pressures is an ongoing credit boom driven by unprecedented global monetary reflationary efforts, as well as the desire of some pension plans to suppress volatility by adding fixed income exposure but simultaneously striving to achieve their targeted returns via leveraged credit. As flows continue into credit funds the demand for fixed income securities continues to overwhelm the supply of debt, further suppressing yields and providing cheap financing for companies. Companies have used this liquidity to repurchase shares at a rate that has fully offset the net sellers of equity securities. With nearly $1.0 trillion in cumulative share repurchases since 2009, a material portion of equity supply has been removed from the market, which will only force prices higher as investors return to the equity markets.



Source: Chart prepared by Brian Reynolds, CFA, Chief Market Strategist at Rosenblatt Securities, Inc.

In 2013 we see a very positive outlook for equities versus bonds. Given the valuation disparity between equity and fixed income it is going to be increasingly difficult for both asset classes to appreciate simultaneously. There is a big difference between price and value, where price is what you pay and value is what you get. The chart below demonstrates this concept. In 1999, the S&P 500 traded at a comparable price to where it ended 2012. However, supporting the market in 1999 was approximately $50 in earnings per share compared to approximately $100 in earnings per share today. Clearly, while the price paid for stocks in 1999 was very close to the price paid today, today's value is much more attractive. This highlights just how far the secular bear market in equities has gone in re-establishing value for stock investors. More importantly, equity markets do not fully reflect the ultra- low yields in the fixed income market and as such stocks need not suffer a permanent loss in value should interest rates rise due to expectations of Fed-induced inflation. The next move for equities is likely to be driven primarily by multiple expansion rather than earnings growth.



Source: Standard & Poors, Factset, Vaughan Nelson; chart data through 9/30/12.
Trailing P/E is based on S&P 500 reported operating earnings per share.
Chart reflects closing prices for S&P 500, thus intraday market peaks and troughs not shown.
Past performance is not indicative of future results.

The earnings recovery from the lows in 2009 is well advanced, but the market remains skeptical of the sustainability of profit margins and future growth potential. To a large extent, the level of multiple expansion and the breadth of participation within equity markets will be driven by public policy decisions, where there are plenty of cross-currents. Existing policy implementation under the Health Care Reform Act and Dodd-Frank financial reform could pressure margins and restrain employment growth. Conversely, if corporate tax reform results in a more streamlined tax code and lower overall corporate tax rates, there could be a material benefit to earnings and an improvement in the confidence of corporate managers. We also anticipate the housing recovery to continue and will ultimately be joined by a recovery in nonresidential construction activity in late 2013. In addition, state and local governments should cease being a drag on economic growth as they are well advanced in addressing their deficits. Other factors affecting multiple expansion include some form of resolution in the euro zone as well as China beginning to increase stimulus to sustain their own growth.

If equity markets only experience multiple expansion, we anticipate that the risk/reward for equities will be generally balanced; with 10% to 15% upside and equal downside risk. However, if multiple expansion is followed by an acceleration in the business cycle, the upside potential for equities would improve.

To be certain there remain possibilities for exogenous shocks in 2013. There are two systemic risks that we believe remain. The first is the ongoing threat of a military conflict with Iran. Should a conflict arise we would anticipate a sell-off in the equity markets but would view it as a buying opportunity as the global economy is well supplied with crude oil. A second potential source of volatility is Japan's aggressive pursuit of higher rates of inflation to offset decades of deflation. Japan is rapidly moving to a position where it will require outside capital to fund its deficits. It is unlikely Japan would be able to source this capital without paying unsustainably high interest rates. As such, should Japan require external financing we would anticipate this need being filled with further rate suppression via quantitative easing and further weakness in the Yen. While this may prove ultimately positive for risk assets, the adjustment process may create short term volatility.

We believe the risk-reward, or value proposition, in stocks is attractive at current levels. In keeping with our long-standing practice, we continue to manage our equity strategies with a focus on investments that should perform well based on above-average returns on capital, sound company fundamentals and valuations that allow attractive returns from current levels. In fixed income portfolios, we start 2013 with basically the same strategy as in 2012. Our current duration target is close to neutral versus the benchmark index, however, we are prepared to shorten duration should a strengthening U.S. economic recovery put upward pressure on yields. While investment grade credit risk premiums have narrowed significantly, most of the fundamental and technical factors that have positively affected corporates over Treasuries remain in place. For taxable investors, municipal bonds remain attractive, particularly intermediate maturity and callable securities.

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