Q1 2011

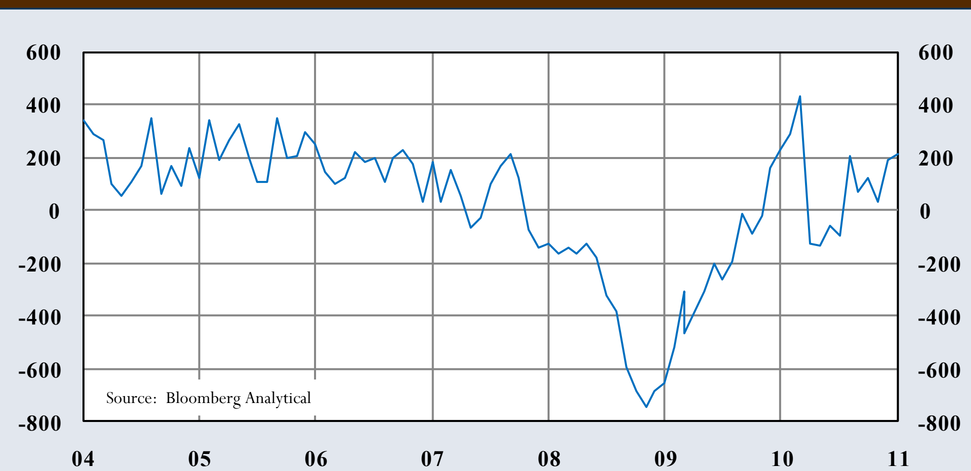
VAUGHAN NELSON

INVESTMENT *perspective*

Stocks and other "risk assets" continued to achieve attractive gains in the first quarter despite an extraordinary number of negative developments, many of which have very uncertain outcomes. A central question confronting investors is whether the financial markets are appropriately discounting the improving economic fundamentals, or are the markets complacent about the growing level of risks both in the U.S. and throughout our interconnected world. Our analysis of the various cross currents leads us to conclude that barring a severe new shock, the U.S. economy can withstand the existing challenges and that the moderate economic recovery will remain intact. Despite all of the headlines of political upheaval in the Middle East and North Africa (MENA), natural and man-made disasters in Japan, potential debt crises in peripheral European Union countries and seemingly no political solutions to our burgeoning Federal deficits, the reality is that the U.S. economy has achieved seven quarters of growth in GDP, including a 3.1% annualized increase in the fourth quarter, and we estimate comparable levels of growth in 2011.

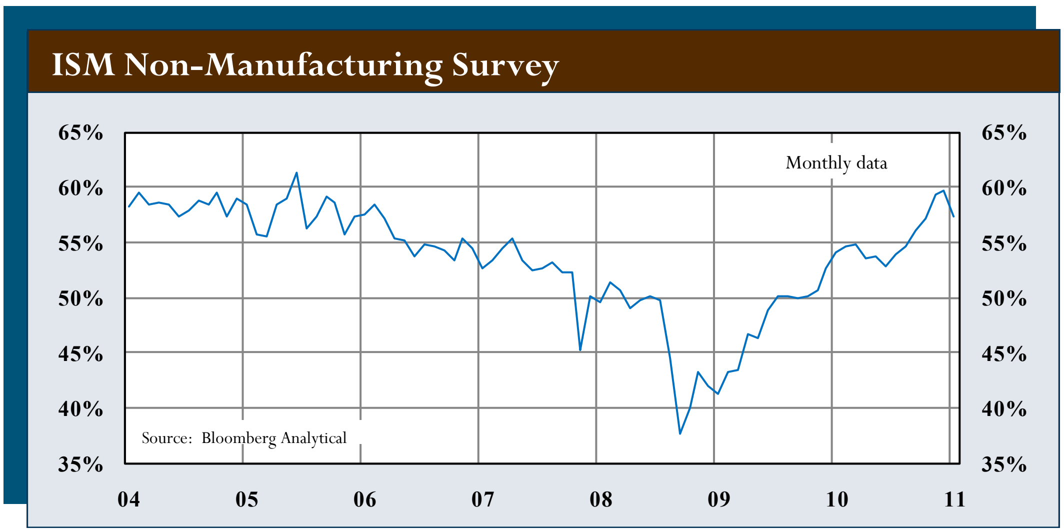
The most important sign that the economic recovery is sustainable is the improving employment market. With 216,000 net new jobs created in March, the average monthly number of new jobs in the first quarter was 188,000, as compared to 146,000 jobs per month in the fourth quarter and 103,000 jobs in the third quarter. Private job growth over the past nine months has more than offset the losses in government jobs, a trend that is expected to continue given state and municipal budget challenges. While average hourly earnings have been flat recently, total private payroll earnings were up 4.2% on an annualized basis due to job growth and a modest increase in the work week to 34.3 hours. This wage growth should help boost near-term consumer spending which was sluggish in the first quarter. Another encouraging sign is that small business hiring, traditionally the primary source of job growth, has been accelerating. According to an ADP report, small companies have created about 100,000 jobs per month over the past four months versus about 30,000 jobs per month last year.

Non-Farm Payrolls (thousands)



While the cyclical upturn in employment bodes well for the economic recovery and the unemployment rate dipped to 8.8% at quarter end, the unemployment level will likely remain elevated. The median duration of unemployment rose in March to 21.7 weeks, and the percentage of the unemployed without work for six months or longer rose to 45.5%, the highest since May 2010. The structural mismatch between the skills required and those available in the labor force will result in a higher than normal unemployment rate for years to come.

In addition to the improving labor market, the closely monitored non-manufacturing Institute for Supply Management (ISM) Survey ticked down in March, yet it registered a strong level of 57.3 last month (levels over 50 indicate an expanding economy). Subcomponents of the index such as new orders and new export orders were 64.1 and 59.0, respectively, pointing to accelerating demand both domestically and abroad.



Reflecting these positive economic fundamentals, corporate profits continue to improve. For 2010, S&P 500 earnings rose 40% from 2009, and consensus expectations are that corporate profits on a trailing 12 month basis will reach a new high in the third quarter of this year. While sales have been solid, the rebound in profitability over the past several years has largely been driven by margin enhancement. Corporate managements have opportunistically "cleaned house" during the downturn and sharply increased productivity levels. Further improvement in margins is unlikely given current high levels and potential pressures from input cost increases such as commodities. However, we do not estimate any significant deterioration in corporate profit margins as compensation expense levels remain constrained by the productivity gains mentioned above and ongoing merger and acquisition activity resulting in continued slack in the labor markets.

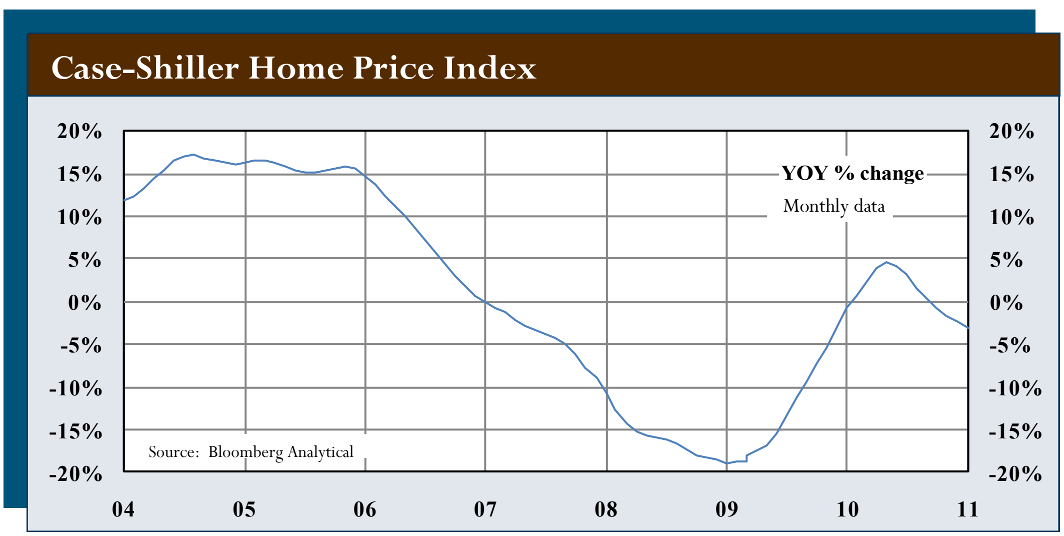
The primary headwinds that could potentially derail the economic recovery are (1) a spike in oil resulting from instability in the MENA region, (2) the European sovereign debt crisis, (3) growing global inflationary pressures and (4) a double dip in the U.S. housing market. We address each of these issues below.

The sweeping changes in the MENA region were aptly described by one long time observer as both "exciting and terrifying." The wholly unexpected and swift departure of President Mubarak of Egypt is a clear example of how difficult it is to predict events in this unstable yet strategically critical part of the world. We believe the current oil price fairly discounts the higher political risks, and barring a major new development such as a drastic supply disruption in Saudi Arabia, we do not anticipate a further spike in the price of oil. The stable and attractive price of natural gas, given ample domestic supplies, has helped to mitigate some of the negative impact the rise in oil has had on the economy, and oil expense as a percentage of GDP has lessened as compared to previous periods of oil price volatility.

The continuing concerns over a possible European sovereign debt crisis have largely been drowned out by news out of MENA and Japan, but serious questions remain as to whether Europe's debt crisis is worsening. Portugal, Ireland and Greece pose the biggest challenges to the solvency of the continent's banking system and the survival of the euro. The inherently complex and political decision-making apparatus of the European Union results in frustrating delays, but in the end we expect leaders to do what it takes to avert a financial crisis. The clear majority of European leaders and their constituents believe that the euro is simply "too big to fail."

Inflationary pressures have risen globally and certainly represent a material threat to economic growth. Recent and expected future contractionary monetary policies in Asia and Europe to dampen inflation will likely result in slower growth abroad, which in turn should help contain further commodity price increases. Our working assumption is that the political pressure to maintain employment growth in China will preclude authorities from taking actions which would result in a hard landing in this key engine of global growth.

Housing activity remains very soft and there are renewed concerns over a "double dip" in U.S. housing prices. While prices in the hardest hit areas such as Nevada and Michigan continue to decline and a large inventory overhang exists, the overall housing market appears to be stabilizing. Total vacant units and vacant units as a percentage of households have started to improve, foreclosures are peaking and 60-90 day delinquencies are starting to decline. Further, the percentage of prospective home buyers is reaching highs last experienced in 1999, and the improving labor market should help drive household formations. Despite these hopeful signs, we would not be surprised to see a further modest decline in home prices. Fortunately, U.S. banks have built significant capital cushions and can withstand an additional 10-15% decline in home prices.



Notably missing from the list of near-term challenges for the economy and the market is a significant rise in interest rates. While inflationary pressures are rising in the U.S. as they are in the rest of the world, we do not expect the Federal Reserve to aggressively tighten monetary policy any time soon. We believe that the Fed is very reluctant to derail the economic recovery, and that Chairman Bernanke is content to allow modest inflationary expectations to rise as an offset to the deflationary impact of ongoing public and private deleveraging and major public spending reductions by states and municipalities. The end of Quantitative Easing II is now just months away with the final purchases of Treasuries by the Fed scheduled for June. We believe the first step in a very long "exit" strategy to unwind the unprecedented level of stimulus injected over the past several years will be for the Fed to cease purchasing Federal debt and slowly reduce its holdings as they mature. While it is likely that the Fed will not raise its key Fed Funds rate until 2012, we anticipate that the market will "lead" the Fed and that interest rates will rise prior to a Fed action. The Treasury yield curve is unusually steep, and we predict that the curve will flatten, with a more significant rise in short-term rates rather than longer term rates. The modest economic recovery and a patient Fed will restrain the overall rise in rates over the remainder of the year.

2-10 Year U.S. Treasury Curve (basis point spread)

Equities are generally fairly valued, and we expect equity markets to consolidate their recent gains in the near-term. We believe the current environment is conducive to rewarding companies with superior fundamentals with above market returns, and that the macro trends have receded in importance. We continue to focus on companies that have better pricing power, higher earnings predictability, higher returns on assets, and stronger balance sheets than the general investment universe. We continue to be confident that we can identify companies with the potential for 50% price appreciation over a three year cycle.

In our taxable fixed income portfolios, we expect to maintain our shorter durations due to anticipated higher interest rates. We will also maintain our bias toward corporate bonds as we expect further improvements in risk premiums given significantly better credit metrics and cash liquidity. Increasing levels of merger and acquisition activity may pose a threat, but the large deals announced to date (e.g. ATT/T-Mobile) have not been heavily leveraged. It appears that corporate managers and lenders endured enough pain in the financial crisis to avoid another such scenario. We constantly re-evaluate our individual corporate holdings and are continuing to upgrade our portfolios' overall credit quality.

The municipal bond market rebounded in the first quarter after a difficult fourth quarter last year. The Intermediate A-rated or better Municipal Index was up 0.70% in the quarter compared to the slight negative return (-0.01%) of the Intermediate Treasury Index. Bond quality is paramount to investors, as evidenced by AAA- rated bonds significantly outperforming A-rated municipals. The average Vaughan Nelson municipal portfolio is AA-rated, as we emphasize safety of principal over a slightly higher yield.

VAUGHAN NELSON

600 Travis, Suite 6300
Houston, Texas 77002-3071

713.224.2545
888.888.8676
713.228.4292 fax

www.vaughannelson.com