VAUGHAN NELSON

INVESTMENT *perspective*

first quarter 2012

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During the first quarter of 2012, the U.S. equity market continued to recover from the sell off experienced in the second and third quarters of 2011. The introduction of the European Central Bank's long-term refinancing operations, or LTRO program, reduced liquidity concerns in the euro zone and globally as well. In addition, U.S. new home construction may be bottoming and a modest improvement in employment trends is lending hope to investors that domestic economic growth will continue to accelerate. While positive for equity markets, these factors led fixed income investors to demand higher yields which pressured bond prices. The Barclays Capital Aggregate Index returned just 0.30% in the quarter. Like the sub-par U.S. economic recovery itself, concerns remain about a slowdown in China, rising oil and gasoline prices, still-worrisome conditions in Europe, and the direction of U.S. governmental policies.

While the recent trends in economic data and employment activity are certainly welcome phenomena, the seasonal adjustment methodology employed by data providers has resulted in a tendency to overstate fourth and first quarter data and then materially underestimate the second and third quarters as these seasonal factors are reversed. As such, we are looking towards April and May data before we will be confident that the recent improvement in employment is more than the lagged effect of an exaggerated downturn and hesitant recovery in hiring activity. Supporting our concern is the fact that the recent improvement in economic data stems primarily from lagging indicators, while leading indicators continue to point to slowing economic activity domestically and abroad. As such, the business cycle remains vulnerable to an exogenous shock or poor fiscal policy decisions.

The global rebalancing that is underway is forcing the peripheral countries in Europe to dramatically lower their standard of living while Northern European countries are forced to accept ever higher rates of inflation. At the same time, China is being pushed toward the arduous task of shifting growth initiatives from an export- led and fixed asset investment -driven growth model to one driven by domestic consumption.

In a heavily integrated global economy undergoing profound changes, the economy that is the most dynamic and has the greatest flexibility is going to be most successful at managing the adjustment process. We see the American economy as ideally suited for this scenario. Despite the recent fear and uncertainty stemming from the credit crisis and dysfunctional political environment, the dynamic U.S. economy has continued to slowly and methodically adjust to the changing environment and in some cases set the stage for significant value creation.

The residential real estate crisis is likely in its latter stages and, while the outlook for home price appreciation remains subdued for a number of years, that is not the case for new home construction activity. Given the rate of household formations and the continued desire by individuals to own homes, we expect to see a steady acceleration in new home construction until we reach annual levels of 1.0 million to 1.5 million units. Depending on the nature of any exogenous shocks and public policy choices we would expect this recovery to occur over the next 2-5 years. This should not only positively affect employment and general economic activity, it will result in a modest acceleration in the velocity of money and ultimately the normalization of monetary policy and interest rates.

In addition, we believe high oil prices will stimulate longer term increases in supply in the U.S. and likely in other producing areas. At the same time, U.S. natural gas remains in abundant supply. Combined, these factors are set to permanently alter the U.S. economy and global geopolitics. We are in the very early stages of this trend and while it will ultimately be very negative for energy and commodity producing equity investments, it is going to have profoundly positive implications for the U.S. economy, our trade deficit and our balance of payments.

Given the strong performance of the market in the first quarter we anticipate that the market will at least consolidate recent gains if not experience a broader correction. A reversal in the seasonal factors mentioned earlier could provide the impetus for the consolidation/correction. We intend to use any correction as an opportunity to build positions in companies meeting our investment criteria, consistent with our view that equity market performance is going to narrow through 2012. We continue to have a positive outlook on corporate credit quality and expect Treasury yields to drift higher. We will continue to manage bond portfolios with a shorter duration than their benchmarks.