Q3 2010

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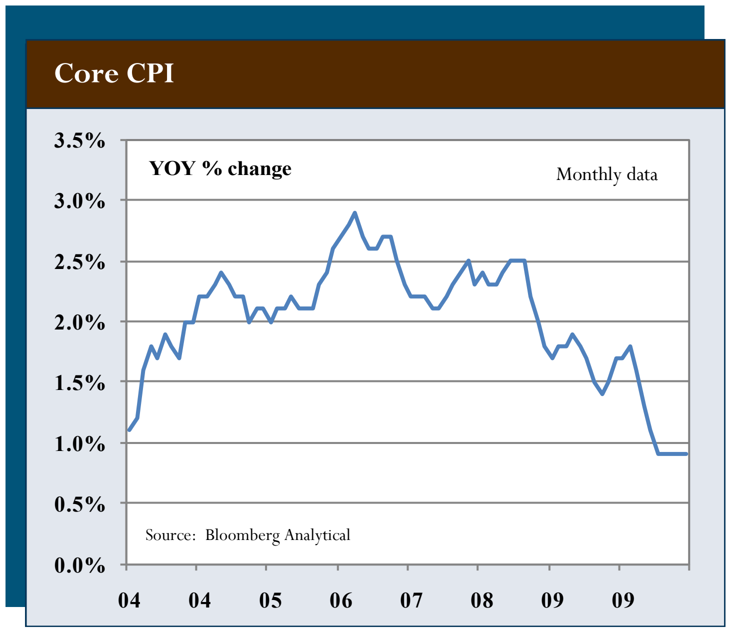
INVESTMENT *perspective*

Amid growing concerns that the economic recovery was losing momentum, at the Federal Reserve's annual Jackson Hole meeting in August, Chairman Ben Bernanke signaled to the markets that the Federal Reserve (the Fed) will do whatever is necessary to foster economic growth and prevent rising disinflationary or deflationary pressures. Throughout September, this message was reaffirmed by Chairman Bernanke and several other Fed Governors, and markets responded favorably to the prospect of additional monetary stimulus. The S&P 500 Index gained 11.3% in the third quarter after a dismal second quarter, and the Barclays Aggregate Index gained 2.5% as interest rates declined.



The sideways but volatile equity markets over the past two quarters have reflected a significant amount of uncertainty over one critical question – is deflation or inflation the more serious threat to the economy? The Fed has now clearly answered this question by stating that the current level of inflation is uncomfortably low, and that aggressive action will be taken to avoid deflation. In all likelihood, the next step is another round of quantitative easing (dubbed "QE2"), and many analysts are estimating that the Fed could potentially purchase up to $1 trillion or more of U.S. Government bonds. Recall that the Fed has purchased almost all of the mortgages created since the beginning of the financial crisis through last March, thus expanding its balance sheet to over $2 trillion.

We believe that Chairman Bernanke and the majority of the Fed Governors are concerned that the combination of a very sluggish economy, continuing high levels of unemployment, and aggressive fiscal austerity plans in Europe and potentially here in the U.S. could increase the threat of a corrosive deflationary cycle. "Helicopter Ben," as the Fed Chairman is known due to a reference he made to a statement by Milton Friedman about a "helicopter drop" of money to help the economy, is also a scholar of the Great Depression. He believes that policy makers made two critical mistakes in the 1930's: (1) allowing banks to fail and (2) letting the money supply shrink. It appears clear that Bernanke is not about to repeat the same "mistakes" on his watch.

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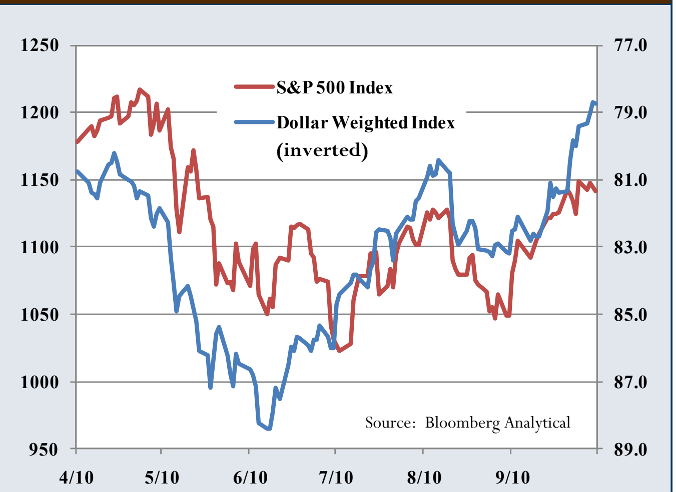
Additional monetary stimulus would offset the ongoing deleveraging and other contractionary trends in the economy, with the potential benefit that it could orchestrate an increase in asset prices, particularly within the still very fragile housing market. Recent estimates show that almost 25% of all U.S. homeowners with a mortgage owe more on their mortgage than the values of their home. Any further loss in value would lead to continuing high levels of foreclosures and significant financial sector losses, which would push the economy into another wrenching recession. Current levels of foreclosures are running about two million homes per year, and the rate of household formation is about one million annually. With over ten million vacant household units, the overhang of home inventory will not improve without a sharp reduction in foreclosures, and any spike in the foreclosure rate would be detrimental to the recovery.

The potential risk is so great that several actions are being discussed in Washington which would offer major relief to "underwater" homeowners. The political climate would seem to preclude any additional fiscal bailout (for this precise reason dealing with Fannie Mae and Freddie Mac was excluded from the Financial Reform legislation), so the Fed may be the only viable source of funding for any such mortgage relief program.

The health of the housing market is inextricably tied to the strength of the employment market, and unfortunately, unemployment levels remain high and are likely to remain so for some time. Additional evidence is emerging that not only are we faced with a cyclical weakness in job growth, but there is also a secular mismatch between required job skills and the available workforce. Many economists now estimate that the natural rate of unemployment has risen to over 6% given this problem and other demographic trends. We side with those who are skeptical that further quantitative easing will have much of a positive impact on employment levels given that employers are very uncertain over future demand levels and the costs associated with ill-defined legislative initiatives. The net result of the monetary actions on jobs may simply be the mitigation of a potentially *worsening* employment situation.

Of course, there is no "free lunch," and aggressive quantitative easing has significant costs and potential risks. The primary negative is the pressure that monetary stimulus will have on the value of the dollar. In the short-term, a lower dollar can spark exports and have positive foreign earnings translation effects. However, over the long-term, a weakening currency typically fosters inflation and discourages capital inflows which will lead to weaker economic growth. No country has ever successfully created new wealth and real long-term value through a weak currency strategy.

S&P 500 vs. Dollar Weighted Index



Given the tepid economic conditions throughout the developed world, the Fed's policy could spark a currency war and a "race to the bottom" as export-dependent economies attempt to maintain competitive currencies. Already, Japan has embarked on a major intervention policy in an attempt to limit the yen's revaluation.

On the positive side, the anticipated next round of quantitative easing has had a positive impact on most risk assets, as reflected in the recent gains in the stock market and most commodities, particularly gold. The correlation between the weaker dollar and the S&P 500 Index is extremely high, and we expect this relationship to remain in place over the near term, providing support to equities.

Another potential positive for the stock market would be a reversal of the massive outflows of funds by individual investors. Year-to-date, the Investment Company Institute estimates that the net outflows from U.S. stock mutual funds is over $61 billion. These funds have largely flowed into bond funds, which year-to-date have seen net inflows of over $243 billion as investors are increasingly desperate to find yield in this extremely low interest rate environment. Other positives for the stock market include the large amount of cash on corporations' balance sheets and the improving prospects for significant stock repurchases, dividend increases and merger activity.

Corporate Cash Holdings % Assets

Source: Federal Reserve, Credit Suisse

After a strong rebound in earnings in 2010 from very depressed levels, earnings expectations going forward will be more muted. Analysts recently reduced their "bottom-up" earnings expectations for the overall market in 2011 to approximately $95, down from the August high and the first reduction in estimates since June 2009. In our equity portfolios, attractive valuation remains the key investment determinate, along with high returns on capital. Our portfolios are constructed to meaningfully participate in further market gains, but also to better withstand any possible downturn.

Interest rates declined during the quarter due to lower than expected global growth and continued "easy money" policies by Central Banks. The largest declines were in the intermediate 5-7 year maturities, and the yield curve continued its flattening trend. While we expected choppy, uneven economic growth, the surprise in our interest rate forecast was the significant shift in Fed policy. Our original expectation was that the U.S. Central Bank would be currently implementing its "exit strategy" for the $2 trillion quantitative easing adopted last year, instead of the now likely prospect of a second phase of quantitative easing.

Despite the near-term prospect of more monetary stimulus, our biggest concern over future returns in the fixed income marketplace remains a rise in the general level of interest rates. We continue to position our taxable bond portfolios with shorter average durations and higher weightings in corporate bonds to cushion the impact

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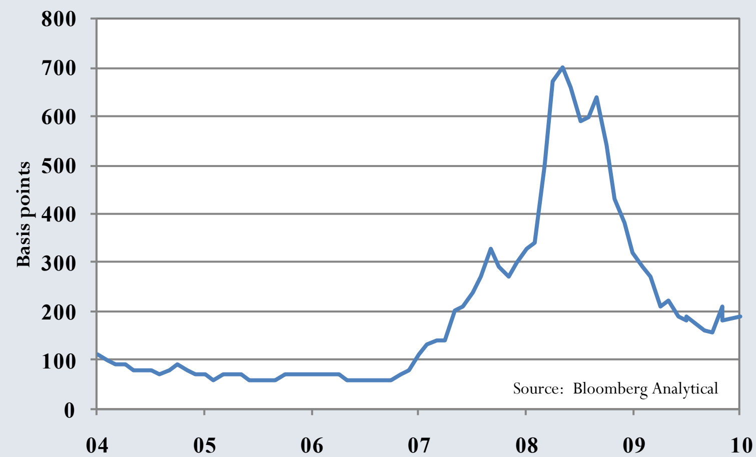
on principal with relatively higher income levels. The yield advantage on the Investment Grade intermediate corporate index versus Treasuries is approximately 175 basis points, and we forecast that these spread levels will narrow to about 150 basis points given improving corporate balance sheets and modest economic growth.

Historical Corporate Bond Risk Premium



Within our municipal bond portfolios we continue to look for attractive high quality bonds that meet two important criteria: (1) direct taxing authority or essential services and (2) a history of balancing budgets. Tax-exempt yields in the 7-year maturity area offer some protection in a rising rate environment, are complementary to our existing portfolio structures, and, when compared to high quality Corporate Bonds, are more attractive on a taxable- equivalent basis.

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