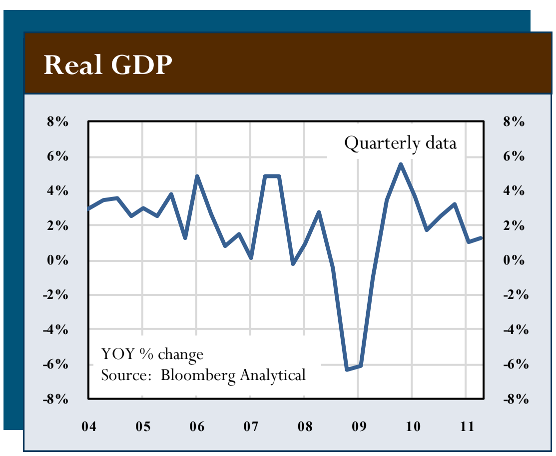
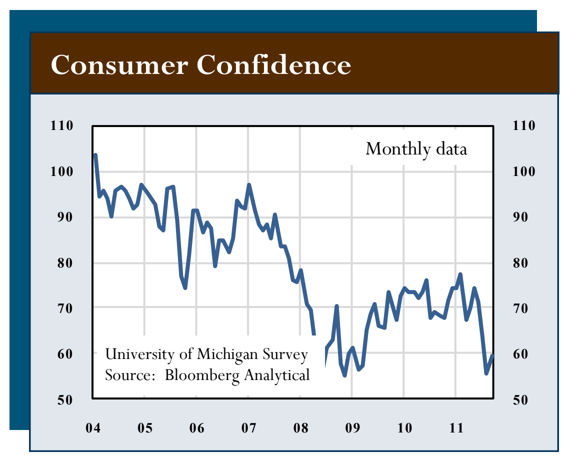
Q3 2011
VAUGHAN NELSON
INVESTMENT perspective

The adage that markets are driven by fear and greed was certainly true in the third quarter as equities and almost all risk assets suffered significant declines due to growing concerns over slowing economic growth globally, and the worsening European debt crisis. U.S. Treasuries soared despite the S&P downgrade during the quarter, as investors sought refuge in the safety of government bonds and interest rates declined to historic levels.

The extraordinary level of uncertainty regarding the potential policy actions in Europe and here at home has had a chilling effect on consumers and business leaders, and it is now clear that our view we expressed in the last *Investment Perspective* that there will be no significant economic recovery in the second half of the year is indeed unfolding. With limited fiscal or monetary tools that policy makers are willing to implement, the probability of the U.S. and the developed world slipping into recession has increased. Even China does not appear to be immune from a slowdown as its export driven economy will likely be impacted by weakened global demand, in addition to the policies Chinese officials have previously taken in an attempt to manage China's inflation pressures and credit market issues.

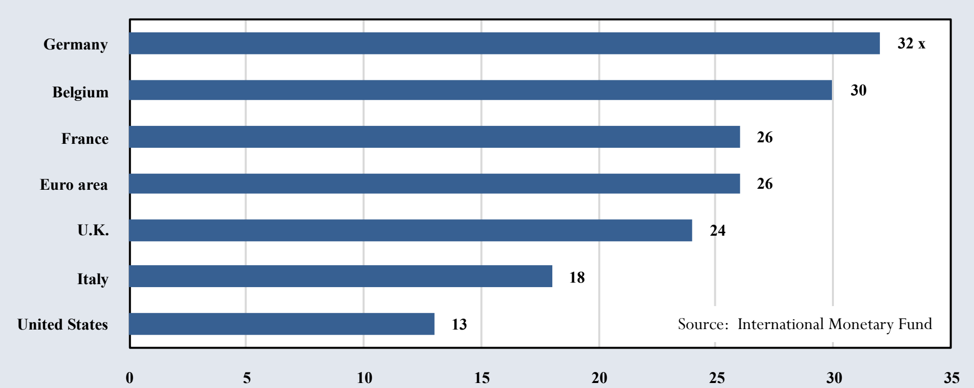




Central to investor anxiety today is the European debt crisis. While it appears that E.U. political leaders finally understand the gravity of the situation, policies continue to be "too little, too late." The very survivability of the euro, unquestioned as recently as the beginning of the year, is now under considerable doubt. European banks already struggling with sovereign debt exposure were hit hard during the quarter by sources of funding drying up as money market funds and other investors pulled massive amounts of liquidity out of the banks. Now given the certainty that major losses will have to be taken on Greek debt, European banks are insufficiently capitalized and will require a much larger source of capital than that provided by the European Financial Stability Facility (EFSF). The EFSF, the latest "solution" to the crisis which was announced last July, is finally expected to be approved by all seventeen members of the European Monetary Union (EMU) in mid-October. The decision-making process required to formulate a solution to this crisis is intensely political, making it virtually impossible to predict the eventual outcome. We believe that a complete resolution will likely require a sharp liquidity crisis or a realization that the

EMU is on the precipice of being disbanded. To resolve the crisis, either a massive transfer of wealth from Germany and France to the other nations will have to occur, or the European Central Bank will have to implement a huge quantitative easing program to prevent the collapse of the European credit markets. In the interim, further delays and squabbling among the member nations provides attractive opportunities to hedge funds and other speculators to take advantage of the uncertainty, and market volatility will remain elevated.

European Banks Hampered By High Leverage

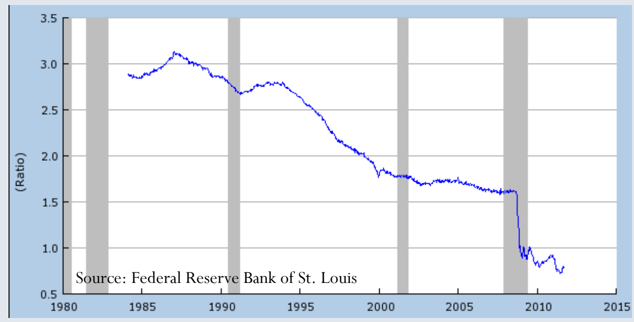


The other critical issue negatively impacting confidence is our own domestic malaise. Whereas the political gridlock in the 1990's helped to reduce fiscal spending and led to an environment where policy actions were a benign influence on markets, the highly partisan gridlock and toxic atmosphere in Washington today has had a debilitating effect on investor sentiment. Now that the 2012 Presidential campaign is in full swing, rhetoric from both political parties is increasingly partisan and often bombastic, making any meaningful compromise on policy matters virtually impossible. Potentially workable solutions to our structural deficit such as the Simpson-Bowles Commission recommendations will likely stay on the shelf until after the election in November 2012.

One possible, yet improbable, shift in the partisan debate could emerge from the Joint Select Committee on Deficit Reduction, or the so-called "Super Committee." The committee is charged with making at least $1.2 trillion in spending cuts over the next decade. If the twelve person committee, comprised of one-half Democrats and one-half Republicans, fails to make a recommendation by November 23 and if legislation is not passed by December 23, then automatic across the board cuts would be implemented, evenly divided between defense and non-defense spending. This committee, which was created out of the embarrassingly protracted debate over the debt ceiling limit last July, has an almost impossible task in this politically charged election season. In short, any fiscal support for the economy in the short-term will be limited.

The Federal Reserve is largely free of political constraints to act, but Chairman Ben Bernanke has been frank that the Fed has largely exhausted all of its tools to spur economic growth. Over the summer, the Fed made the surprising announcement that it would maintain its near-zero interest rate policy through at least mid 2013, and rejected a major Quantitative Easing III program. Instead, the Fed implemented "Operation Twist" in late September, which calls for selling $400 billion of short-term Treasuries and buying the same amount of longer term Treasuries and mortgages in an attempt to lower interest rates on longer maturity bonds. In his recent Congressional testimony, Chairman Bernanke estimated that the targeted reduction in interest rates was a modest 20 basis points, further evidence that the Fed has little ammunition left to support the economy. Further, the Fed has been clear in communicating the limited long-term effectiveness of quantitative easing strategies given structural issues in the employment and housing markets, and has stated that appropriate fiscal and regulatory actions are now required to help create an environment conducive to capital investment and enhanced consumer confidence. Therefore, in the near-term, we do not anticipate any significant changes in monetary policy. If global economic conditions worsen markedly, we anticipate that the Fed will launch a highly aggressive purchasing program which would materially increase the size of the Fed's balance sheet. The objective of such a policy would be to avert a potentially damaging deflationary cycle and to "create" inflation in order to increase the money multiplier (velocity) and diminish the burden of the massive debt overhang.

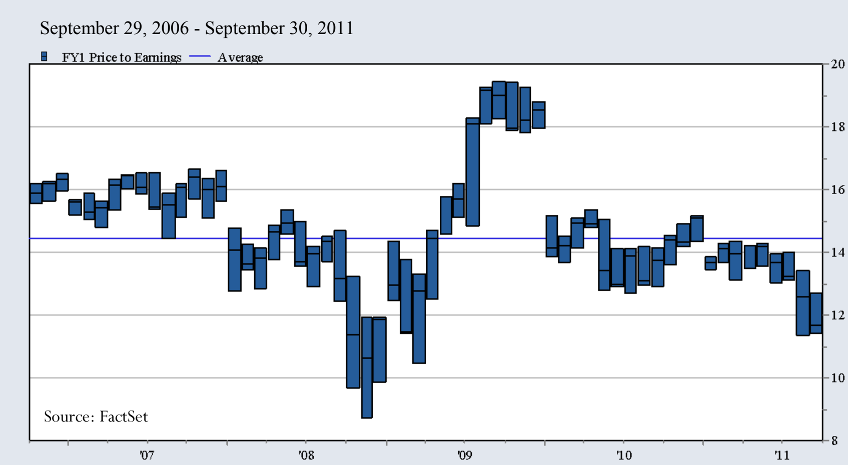
Money Multiplier



While our short-term equity market outlook is clearly cautious, we remain optimistic regarding the intermediate and long-term. U.S. banks are generally much better capitalized than their European counterparts, and U.S. corporations are highly liquid and competitive. Policy actions such as meaningful tax reform both at the corporate and individual level, together with appropriate regulatory reform, would have a very beneficial impact on corporate earnings, investor sentiment and likely enhance the market's valuation multiple.

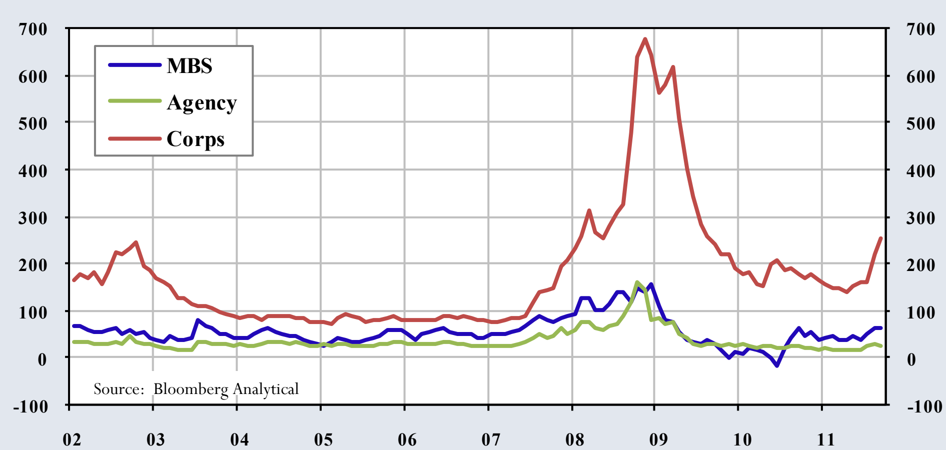
Additionally, while our working assumption is that the economy will weaken over the next several quarters, the market should move higher before the trough in economic activity, which we expect to occur in the first half of 2012. During the third quarter, in anticipation of the economic slowdown, we further reduced the cyclical exposure in our equity portfolios. We continually monitor leading economic indicators to assess inflection points in the economy, and we are prepared to reposition our equity portfolios very rapidly in order to take advantage of the cyclical recovery and to build positions in deeply oversold securities.

S&P 500 Price/Earnings Ratio



The bond market rally during the third quarter was largely isolated to the Treasury markets. While investment grade corporate bonds returned a positive 3%, they lagged well behind the 6.5% return on Treasuries. The U.S. credit markets were impacted by the same "risk off" trades which caused significant declines in equities and high- yield bonds in the quarter. While we see significant value in the current higher risk premiums on high quality corporate bonds, stability in the credit markets will require credible headway from European and U.S. policy makers on deficit/debt reduction plans. In our taxable fixed income portfolios, we see attractive opportunities along the yield curve and in high quality corporate issues.

Investment Grade Risk Premiums (basis points)



For taxable investors, municipal bond yields are at historically low levels, but are attractive relative to alternatives such as comparable maturity taxable bonds or money market funds with near-zero rates of return. While longer term municipal bonds offer higher interest rates than intermediate maturities, the principal risks are substantially higher as interest rates return to more normalized levels in the years ahead. Our disciplined process of managing reinvestment risk helps to moderate the decline in near-term interest income in municipal bond portfolios. It has been one year since a noted Wall Street analyst infamously predicted that there would be "hundreds of billions" in municipal bond defaults over the next twelve months. The reality has been far different, with states and municipalities constructively dealing with their budgetary constraints, and defaults have amounted to less than 0.1% of the overall municipal market year-to-date.

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