VAUGHAN NELSON

INVESTMENT *perspective*

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Over the past year we saw significant headline risk from sovereign debt problems within the Eurozone. While volatility escalated, the net impact on U.S. equity markets was negligible. Markets retreated when investors extrapolated dire outcomes associated with uncontrolled defaults only to reverse and bid up assets when a less painful solution was in the offing. Does that mean the coast is clear and we are back to more normal markets? We are doubtful.

Post the Great Recession the private sector has steadily deleveraged while the public sector has leveraged up to offset the deflationary pressures and to delay loss recognition and structural entitlement reforms. However, political pressure in the U.S. and excessive sovereign interest costs in Europe are pressuring politicians to adopt more austere fiscal policies. While the U.S. Government still has support from the bond market to continue to increase outstanding indebtedness, Europe has finally come to the end of its ability to increase indebtedness in order to maintain their current standard of living. Therefore, in the coming year we will finally begin to realize losses from the Great Recession.

The greatest uncertainty and potential volatility stems from Europe's approach to resolving their sovereign debt crisis. Two policy options are available. The first option is severe austerity measures and higher taxes, which would produce significant deflationary pressures. The second option is an expansion of the monetary base and consequently an increased risk of inflation. Unfortunately investors have very little insight regarding the probability of either binary outcome at a time when the resulting outcome can have a dramatic impact on specific investment opportunities. Consequently, we have reduced our exposure to the Eurozone in order to insulate the portfolios from such unknowns.

With much of the Eurozone currently in a recession, global economic growth continues to slow. In response, global central banks have begun to shift from a restrictive monetary stance to one designed to increase reflationary pressures. Despite this recent shift we continue to expect U.S. economic growth to moderate, increasing the risk of recession in the U.S. Throughout 2012 we expect a significant increase in global reflationary policies will be necessary to support a reacceleration in economic activity in the second half of 2012. While the headlines may alarm, the losses are already known to the financial markets and thus an outsized market reaction should not necessarily be expected.

Within client equity portfolios we continue to focus on companies that have better pricing power, lower earnings variability, higher profitability and stronger balance sheets than the broader investment universe. We do not favor any single industry sector, and continue to look for the characteristics noted above across all industries. With the uncertainties regarding economic growth globally, and the additional uncertainties regarding regulatory, tax and fiscal policies in the U.S. and the Eurozone, market volatility is expected to continue. We are using this volatility as an opportunity to add to or reduce positions as prices deviate markedly from our internal valuation work. The Federal Reserve's expressed intention to raise inflation expectations and maintain nonconventional policy actions could result in material unintended consequences. As such, we will remain vigilant of the macro risks that could impact specific industries and business models and are prepared to reposition the portfolio accordingly.

In taxable fixed income portfolios we are maintaining a shorter duration stance and an underweight to Government securities. In 2011, sovereign debt concerns, weakening global growth and the Federal Reserve's easing program dubbed "operation twist" all helped to drive down yields on longer duration U.S. Government securities. However, the rally in Treasury bonds and the increase in high quality corporate bond spreads will likely reverse and the risk of higher interest rates now outweighs the reward. Our expectation of continued sluggish economic growth and generally low interest rates has historically been an environment where investment grade corporate bonds have outperformed. However, the risk of a global policy mistake is heightened and thus being positioned in solid credits and opportunistically transacting in specific bonds where the market misprices the risk premium will be important.

In 2011 the municipal bond market benefitted from the highly publicized call in late 2010 by renowned equity analyst Meredith Whitney that there “would be billions of dollars” of municipal bond defaults. While we did not share her belief, her call led to a significant liquidation from municipal bond funds, the end result being a grossly undervalued market at the start of 2011. The combination of a gradually improving U.S. economy, a rebound in revenues and cuts in spending by state and local governments, resulted in an overall default rate below the historical average. In the current fairly valued municipal market, some investors will be tempted to increase their portfolio income by extending maturities or purchasing lower quality bonds. While we see opportunities in some undervalued callable bonds, any purchases we make would be in the context of maintaining the average maturity and duration at close to current levels. Over the next few years we should move into a higher interest rate environment. Until that time protection of principal and managing reinvestment risk will be our primary focus.