

Investment Perspective

For the year ended December 31, 2011, the Barclays Capital Intermediate Government/Credit Index (BCIGCI) returned +5.80%. For the quarter ended December 31, 2011, the Barclays Capital Intermediate Government/Credit Index (BCIGCI) returned +0.84%. U.S. Treasuries (+0.89% quarter, +9.81% year) realized positive returns for the year as the yield curve shifted in a bull flattening fashion. In this environment, long Treasuries (+1.86% quarter, +29.93% year) outperformed intermediate Treasuries (+0.72% quarter, +6.57% year) by 2336 basis points, the largest margin on record. Treasuries benefitted from a flight to quality as Europe weakened while Greece's situation deteriorated. Treasuries were also bolstered by coordinated efforts to lower interest rates and stimulate the global economy by central banks around the world including the Federal Reserve which itself purchased \$400 billion in longer dated Treasuries.

Mortgage-backed securities (+0.88% quarter, +6.23% year) underperformed duration-matched Treasuries by 106 basis points during 2011. Mortgages underperformed as the option-adjusted spread (OAS) of the Barclays Capital U.S. Mortgage index ended the year at 75 basis points, 33 basis points wider than a year ago. Mortgages underperformed as U.S. Government programs aimed at stimulating the housing market led to concerns of increased refinancing activity and expectations for faster prepayment speeds.

Although credit securities performed well in 2011 (+1.70% quarter, +8.35% year), they underperformed duration-matched Treasuries by 322 basis points. Long credit (+3.21% quarter, +17.13% year) outperformed intermediate credit (+1.13% quarter, +5.37% year) by 1176 basis points, benefitting from a longer duration profile in a declining interest rate environment. On a duration adjusted basis however, long credit underperformed intermediate credit by 499 basis points spreads as the effects of widening during the year was more pronounced on the long end of the curve. The option-adjusted spread (OAS) of the Barclays Capital U.S. Credit Index ended the year at 217, 71 basis points wider on the year.

Financials (+1.22% quarter, +3.15% year) were the worst performing credit subsector in 2011 underperforming industrials, (+2.28% quarter, +10.47% year) utilities (+2.24% quarter, +13.23% year) and the non-corporate sector, which includes sovereigns, supranationals, foreign agency, and foreign local government (+0.84% quarter, +9.14% year) by 395, 468 and 479 basis points of excess return, respectively. Higher quality investment grade securities outperformed in 2011. Although AAA securities realized -97 basis points of excess return during the year, this quality bucket outperformed AA, A, and BBB rated securities by 194, 274, and 255 basis points of excess return, respectively.

Economic and Market Outlook

Following the conclusion of its December meeting, the Federal Open Market Committee (FOMC) stated that recent data suggests the U.S. economy has been "expanding moderately, notwithstanding some apparent slowing in global growth." The Committee noted certain indicators such as household spending showed further improvement. Additionally, inflation levels moderated and were unchanged in November as the prices of key consumer expenditures

such as gasoline decreased -2.4%, matching the Committee's expectations. While the Fed acknowledged, "some improvement in overall labor market conditions, the unemployment rate remains elevated." The Fed reiterated its outlook for "a moderate pace of economic growth over coming quarters and anticipates that the unemployment rate will decline only gradually toward levels consistent with its dual mandate". Thus, in our view, it is unlikely that the FOMC will move from accommodative policy during 2012, absent a significant decline in unemployment or a material change in long-term inflation expectations.

Uncertainty surrounding the health of European economies and financial institutions weighed heavily on global financial markets in 2011. As a result, investors dealt with persistent volatility throughout the global financial markets, resulting in a flight-to quality in 2011. In such a "risk on, risk off" environment, corporate bond spreads widened regardless of the issuer's direct exposure to Europe, if any, as investors consider a potential disconnect between the domestic economy and those abroad. While the global nature of the European crisis cannot be overlooked, a significant portion of U.S. corporations carry little direct exposure to Europe, and furthermore, an even greater number have been scaling back investment in Europe since before the crisis emerged. In our view, the outcome for U.S. corporate bonds is more contingent on the domestic economy and the degree to which sound financial discipline has allowed issuers to utilize the low interest rate environment to improve their balance sheets. On a relative basis, corporate bonds issued by entities that have termed out liabilities, demonstrably reduced their debt burden and continue to produce strong cash flow throughout the business cycle remain attractive.