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INVESTMENT GRADE COMMENTARY

Fourth Quarter 2011

Market Review

Risk assets generated positive performance during the fourth quarter. The Barclays U.S. Credit Index outperformed duration-neutral Treasuries by 61 bps. The 10-year Treasury yield declined 6 bps, and the spread between 10-year and 2-year Treasuries flattened by 4 bps, ending the quarter at 164 bps.

The Barclays U.S. Credit Index tightened by 31 bps in October, outperforming Treasuries by 238 bps. In November, the index widened by 38 bps, underperforming Treasuries by 257 bps. The index tightened in December by 8 bps, outperforming Treasuries by 83 bps.

Except for the non-corporate sector, all of the major credit sectors outperformed Treasuries for the quarter. Paper was the best performing sector, and brokerage was the worst performing sector, led by Jeffries.

October

The Barclays U.S. Credit Index tightened by 31 bps in October, regaining spread widening from the previous month, and it outperformed Treasuries by 238 bps. European headlines on the sovereign crisis tended to be more positive during the month. U.S. economic data releases surprised to the upside, prompting a risk-on trade for the month. Rebounding higher-beta credits were the best performing sectors, while the highest quality sectors underperformed. A few security-specific events influenced sector performance, as well. The best performing sectors were paper (Georgia-Pacific, International Paper, Domtar), media cable (Time Warner, Comcast, DirecTV), metals and mining (Newmont Mining, ArcelorMittal, Barrick, Cliffs), oil and gas (Nexen, Anadarko, Williams) and wirelines (all the EuroTels, and CenturyLink). The worst performing sectors were brokerage (MF Global default), building materials (Owens, Legrand), lodging (Hyatt, Marriott, Choice), supranationals and packaging (Sonoco, Avery Dennison).

November

The Barclays U.S. Credit Index widened by 38 bps, underperforming Treasuries by 257 bps during the month and reversing October gains. Politics and policy risk remained at the forefront. As the Congressional super committee failed to agree on budget cuts and as hopes for a resolution to the European debt crisis eroded, spreads leaked wider through most of the month. At the end of the month, a few positive comments came from Europe, but they were too late to affect performance materially. The best performing sectors were lodging (Wyndham upgrade, Marriot, Choice), other industrial (university bonds: Princeton, Cornell, Dartmouth, Vanderbilt), foreign/ local governments and small sectors of other financials and airlines. The worst performing sectors were refining (Valero, Marathon), media cable (Comcast, Time Warner Cable, DirecTV, Virgin Media, Cox Communications), brokerage (Jefferies, Nomura, Ameriprise, H&R Block), life insurers (AXA, AIG, MetLife, Prudential, Hartford) and oil field services, (Transocean, Halliburton, Baker Hughes, Weatherford International, Ensco).

December

The Barclays U.S. Credit Index tightened by 8 bps, outperforming Treasuries by 83 bps during the month, due to better headlines out of Europe. Actions taken by the ECB meeting and comments from the EU summit provided some stability to the market and reduced concerns about near-term systematic risks to the U.S. markets. The best performing sectors were non-bank financials (General Electric Credit, SLM), tobacco (Altria, Lorillard), and refining (Marathon, Valero). The worst performing sectors were foreign/local governments (various Build America municipal bonds) and lodging (Choice, Wyndham, Marriot).

Fundamentals

The U.S. economy, on the margin, seems to be improving. Economic releases generally have met or exceeded expectations. The U.S. is still vulnerable to external shocks, however. While glimmers of light have peeked through the eurozone's dark clouds, with favorable comments coming from political leaders, we have not yet seen actionable solutions. Uncertainties surrounding the China/Asia rate of growth and development have contributed to negative sentiment, as well. We believe macro headline risk is skewed to the downside in the near term.

U.S. company balance sheets continue to be in good shape, and liquidity is solid for most sectors. Corporate profits are strong, lending to meaningful free cash flow generation. We would expect to see some companies return cash to shareholders through dividends and share repurchases. We see the potential for an increase in debt-financed M&A transactions, given the low-yield environment. Slow economic growth will likely keep companies cautious, however, limiting the amount of M&A activity.

The U.S. banking system will stay in the headlines due to concerns about eurozone exposure and potential regulatory changes such as the Volker rule. Despite the potential for more negative headlines, we believe bank capital ratios are fundamentally stronger and will continue to improve due to changes in banking regulations and Basel III. In addition, we expect rating agency activity for the sector to be limited relative to last year. Overall, core fundamental factors support tighter spreads going forward, but risks to the downside will outweigh our appetite for taking on more credit risk until we see a few more positive signs.

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Technicals

Daily macro-driven headlines, predominantly centered on the European crisis, continue to drive investor sentiment. Core supply and demand factors tend to be positive. Flows into the investment grade asset class generally are strong, supporting demand for product, and dealer inventories are at historically low levels. Offsetting these core strengths, low all-in yields and limited risk budgets are keeping pressure on any meaningful spread tightening. In addition, the uncertainty surrounding expected regulatory reform is affecting market liquidity by reducing the broker/dealer's ability to hold larger inventories and serve as an active market maker. As a result, we expect higher levels of volatility when market-moving events occur.

Valuation

Based on historical measures, spreads appear relatively attractive when compared to current healthy credit metrics. Furthermore, when compared to equity volatility, investment grade credit spreads look reasonably cheap. Any tangible solutions to Europe's financial crisis could cause meaningful spread tightening. Moreover, political risk still resonates high, both domestically and globally. Low Treasury yields also influence current spread levels, resulting in the façade of cheap valuations. Consequently, we remain constructive on spread tightening longer term, but our low conviction warrants an assessment closer to fair value.

Sector Views

We remain constructive on the banking sector, though we prefer strong regional bank credits and select high quality banks over money center banks. We favor credits that are somewhat insulated from eurozone crisis contagion. We are holding our view that financial regulatory reform will make banks fundamentally stronger in the long run, but headlines will drag the spread recovery out for some time.

We recommend maintaining a modest strategic overweight to credit with specific overweight allocations to finance (banking and P&C insurance) and commodity-based sectors. We recommend underweights to sectors and issuers that have limited revenue growth potential and are exposed to shareholder-friendly activity and event risk. We suggest an underweight to consumer sectors that have limited revenue growth potential. Consumer products and food and beverage are likely to underperform due to event risk, increased shareholder-friendly activity and rising input costs, which pressure their margins. We recommend underweights to European credit credits, especially to the peripheral European countries. We also see opportunity in select non-corporate securities, including taxable municipals and Build America Bonds.

Summary

Based on valuations and underlying core company fundamentals, we remain constructively optimistic for credit spread tightening. During the last half of 2011, the credit markets re-priced risk to more fully price in the uncertainty surrounding Europe, U.S. fiscal policy and financial regulatory reforms. This reduced the potential downside risk associated with more spread widening. Nevertheless, we are not convinced we will see sustained spread tightening. Until we see evidence of a definitive resolution to the European issues, we don't expect to have a lasting spread rally based on traditional credit fundamental, technical and valuation methods. Likewise, any further U.S. economy slowdown or global contagion will keep spreads at historically wide levels in combination with historically low Treasury rates. We expect spread volatility to be higher than average due to the lack of overall market conviction and reduced market liquidity.

We recommend that investors continue to construct portfolios that are overweight to clearly defined positive credit fundamentals and have below-average exposure to the uncertain risks associated with Europe. We believe they should position their portfolios with a defensive bias, while remaining poised to take advantage of periods of market weakness. Ultimately, we believe that investors will be rewarded once the market returns to focusing on traditional fundamental and technical factors to value credit risk.

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