

Q1
2009

VAUGHAN
NELSON

INVESTMENT *perspective*

\$12.8 trillion. As of March 31, 2009, this was the total amount that the U.S. Federal authorities had guaranteed, loaned, spent or committed to spend in response to the financial crisis. The absolute dollar amount is staggering on its own, but to put that number into perspective, it is close to the nation's total output in 2008 of \$14.2 trillion. These are clearly extraordinary times.

The Federal Reserve, the U.S. Treasury and the F.D.I.C. have collectively shown to have an open ended commitment to resolve the financial crisis and to limit the depth and duration of the recession. Through various initiatives, the following Federal policies and programs have been implemented over the past six months:

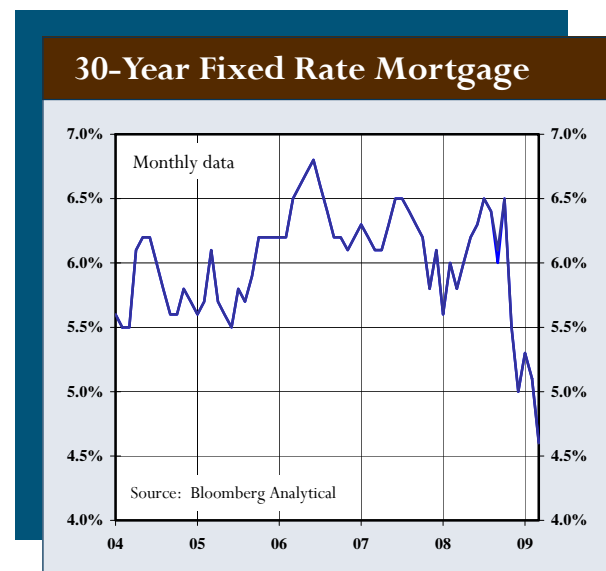
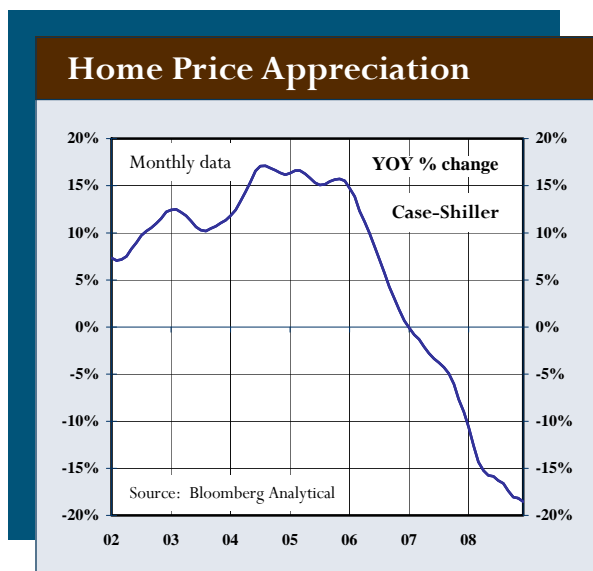
- adopting a zero interest rate policy
- avoiding any additional bankruptcies of any financial institutions which could lead to systemic risk
- providing credit to corporations and consumers
- directly purchasing risk assets
- using quantitative easing to fight deflation
- approving a second fiscal stimulus plan
- creating a plan to entice private capital to purchase troubled assets from banks.

This last initiative, the Public-Private Investment Program (PPIP), was greeted with a strong stock market rally when it was unveiled on March 23rd by Treasury Secretary Tim Geithner, in sharp contrast to late February and early March when the markets were roiled by the delay and lack of specificity in Treasury's plan to remove the "toxic assets" from banks. We are skeptical that the PPIP will be as successful as many seem to expect given our view that the banks may not accept the distressed values to be offered by the PPIP participants. Our skepticism was heightened by the early April decision by the Financial Accounting Standards Board (FASB) to modify "mark to market" accounting which will provide banks with the mechanism they need to value illiquid assets at a higher valuation than the private financial firms will likely be willing to pay.

A more probable scenario in our opinion is that the PPIP will fail just about the time that Treasury's "stress tests" of the largest banks is complete. We estimate that the stress tests will show that some banks require significant amounts of additional capital, and with the banks' and investors' reluctance to participate in the PPIP, the Federal Authorities will have the "club" to force the banking system to recapitalize. The recapitalization of the U.S. banking system is one of three critical steps which must be accomplished in order for the financial system and the economy to mend. While the path will be bumpy, we are increasingly optimistic that this arguably most important step is getting closer to being achieved, and the vital role that banks play in providing credit to the economy will be restored.

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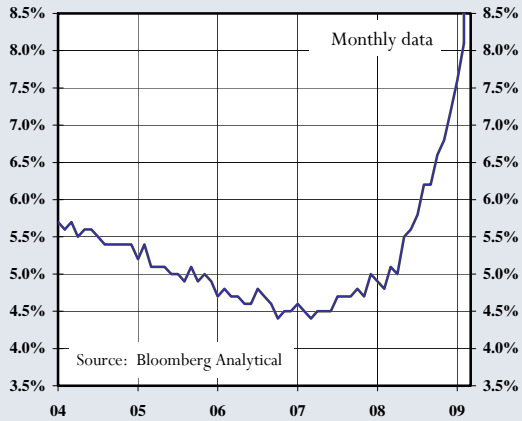
However, we believe more progress is needed toward the resolution of two other essential elements in the crisis: 1) a stabilization in housing prices and 2) a decline in the rate of growth of unemployment. There have been some recent positive trends in new and existing home sales and in mortgage refinancings resulting from direct purchases of mortgages by the Fed. These Fed actions have driven conforming mortgage rates to under 5%. Unfortunately, housing prices continue to decline as evidenced by the 2 ½ % monthly drop in the widely followed Case-Shiller housing price index which resulted in a 19% year-over-year decline in home prices in January. Additionally, delinquency rates are rapidly rising according to Fannie Mae and Freddie Mac, which together hold one-half of the nation's mortgages. Fannie Mae's January delinquency level was 2.8% and Freddie Mac's was 2.1%. CreditSights, a leading research firm, estimates that delinquency levels could approach 4% over the next several years. About the only "good news" in the housing area is that selected markets which have declined by 50% from peak 2007 levels seem to be bottoming. Our view is that on a national basis housing prices will experience further declines over the next several quarters, although the rate of decline is showing signs of slowing.



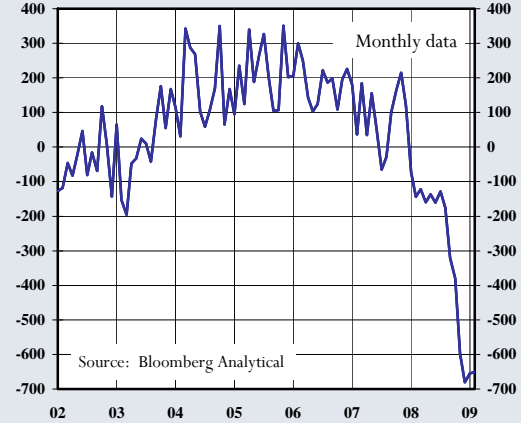
Housing sector problems are exasperated by the very weak labor market. March's payroll report of a net loss of 663,000 jobs and an unemployment rate of 8.5% are further proof that labor market conditions continue to be dismal. If those individuals who work part-time but want a full-time job, and those unemployed discouraged workers who have stopped looking for jobs but want to work are added to the calculation, the unemployment level is 15.6%. While unemployment is a lagging economic indicator and the economy can turn positive while unemployment continues to rise, the rate of growth of unemployment must decline before a sustained economic recovery is possible. We predict the labor market will not reach this stage until the second half of the year, and we continue to estimate that peak unemployment will hit double digits.

One of the key future risks we are closely monitoring is the commercial real estate sector. Whereas the residential real estate market may be nearing the end of its painful decline, the commercial real estate sector is likely in the early stages of a very weak cycle. Driven by tenants' needs to reduce costs and slumping employment levels, the office market vacancy rate recently hit 15.2% with many predicting that vacancies could rise to 19% next year. If reached, these levels would top the previous record set in the early 1990's. If this sector declines further than current expectations, banks and insurance companies will be forced to take additional writedowns which will increase their need for new capital.

Unemployment Rate

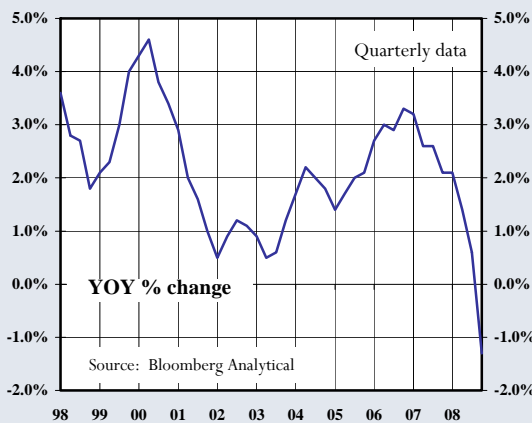


Non-Farm Payrolls (000's)

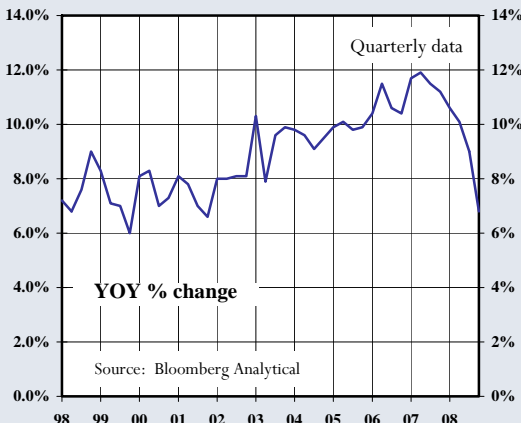


The financial crisis is global in nature, and actions being taken outside of the U.S. to deal with the crisis are decidedly mixed. The most positive international actions are being taken by the Chinese to stimulate their economy, and Asian stock market performances are reflecting early promising signs from this increased spending. The G-20 meeting in early April produced two tangible results: 1) the pledge of \$1.1 trillion for the International Monetary Fund and 2) less protectionist rhetoric. On the negative side, the European Central Bank (ECB) continues to lag other Central Banks and recently pegged its key interest rate at 1.25% as compared to 0.5% in the U.K. and the zero to 0.25% target rates in the U.S. Additionally, European nations are reluctant to increase their fiscal stimulus plans given their already existing large “safety net” spending programs. Finally, efforts to recapitalize the European banking system have been limited. Inadequate actions abroad have led many economists to forecast a deeper economic slump, including the World Bank which is now forecasting that global output will decline 1.7% in 2009, the first time the world economies will have possibly contracted since World War II.

Eurozone GDP



China GDP



Equity markets in the first quarter were highly volatile and during the first two months were negatively impacted by the weak economic fundamentals and by some major missteps by Congress, Treasury and the Administration. On March 9, the S&P 500 reached a new low for this bear market, and subsequently the market rallied quite sharply. Some early signs of bottoming in consumer spending, housing sales and consumer confidence, along with the PPIP introduction and the Administration's opposition to the punitive bonus taxation legislation passed by the House of Representatives, all helped to shift investor sentiment. The market was further propelled higher by massive short covering. Our working assumption is that the equity market will retrace some of its recent gains, and that markets will continue to be volatile and range bound until the three critical issues discussed above show further improvement.

A key requirement of our equity holdings is that the companies are not subject to refinancing risk and are not dependent upon external capital to fund their growth. The companies we own produce attractive returns on their invested capital and produce significant cash flow to reinvest in their business. Given the continuing high level of uncertainty over the near term direction of the economy, our equity portfolios are highly diversified and are comprised of individual companies which have the characteristics to emerge from this period with enhanced competitive positions.

Some portions of the fixed income markets have experienced marked improvement in liquidity, particularly in the money market/cash transaction area, due to the Federal programs already in place. As greater clarity of the success of programs presently being finalized occurs, liquidity within the overall credit markets should improve and all risk assets would attract the significant amount of capital now parked in Treasuries. Unfortunately, this could lead to significantly higher Treasury yields, although we believe at the earliest this is a late 2009 or 2010 event.

During the quarter, ten-year Treasury yields rose 45 basis points even with the Fed's quantitative easing program to buy \$300 billion of Treasury securities underway. The yield curve during the quarter (from two year to ten year Treasuries) steepened from 145 basis points to 185 basis points. While the purchase of Treasuries is intended to keep yields low in order to support the mortgage market and the economy overall, the purchasing is countered by the estimated one trillion dollars of Treasury issuance in 2009. We continue to position our bond portfolios with shorter durations and with the expectation of a steeper yield curve, and we see good value on a risk adjusted basis in investment grade corporates, particularly in the shorter/intermediate maturities.

For our taxable clients, while the press has written extensively about the troubles municipalities are facing from a budget standpoint, it is important to remember most taxing authorities are required to balance their budgets. So while this is painful for local constituents in the form of reduced spending and higher taxes, it is an important positive for the credit protection bond investors demand. We continue to favor two to seven year municipal bonds, compared to extremely low tax-exempt money-market yields.

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