

Q3
2009

VAUGHAN
NELSON

INVESTMENT *perspective*

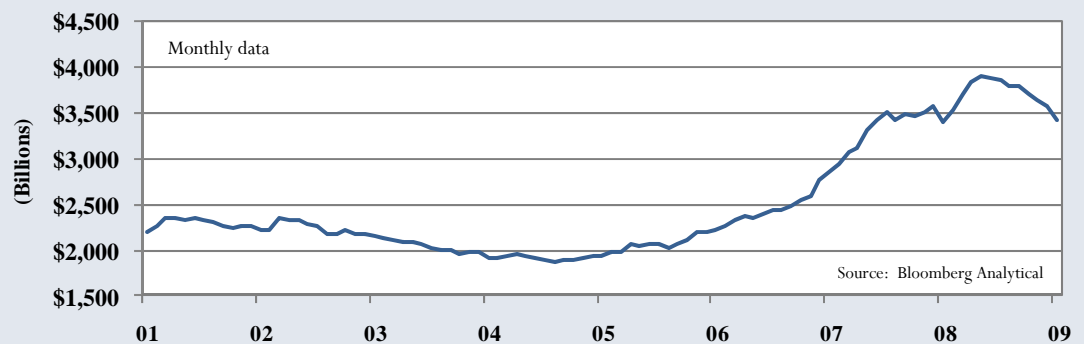
The market rally which began in March continued in the third quarter. The S&P 500 Index was up 15.6%, the best quarterly performance for the broad index since 1998 when markets were rebounding from the Asian crisis. Bond investors achieved solid returns as interest rates declined during the quarter and spreads narrowed, particularly in the corporate bond sector.

With no additional Federal programs introduced during the quarter, investors were able to refocus on economic fundamentals, and the economy exhibited improving trends in the quarter. Severely depleted inventory levels resulting from a sheer drop off in demand over the previous two quarters is spurring a strong inventory replacement cycle. Corporate earnings, while still down from the previous year, were better than expected due to stringent expense management. In addition to slashing inventories, employers continued to cut payrolls (private-sector payrolls are lower today than they were in 1999) and took advantage of the reinvigorated credit markets to refinance debt at attractive interest rates.

The financial system regained its footing during the quarter as banks and other financial institutions strengthened their balance sheets with profits earned from a steep yield curve and from significant equity issuance. Several recipients of Federal TARP funds repaid their government borrowings and most of the other participants have expressed their intention to do so.

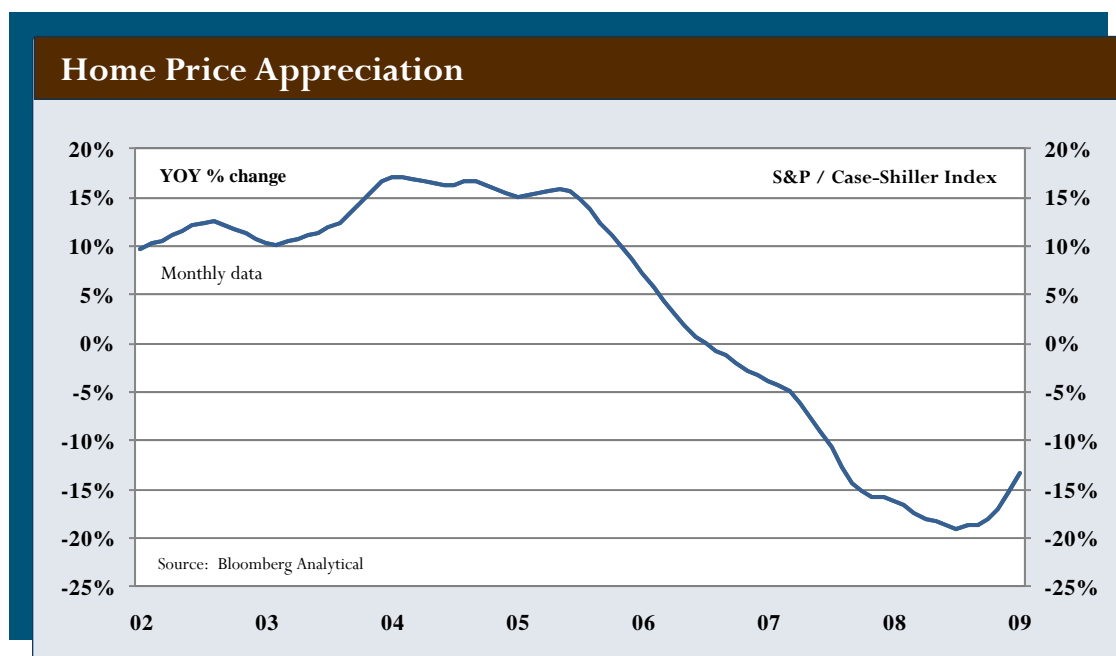
Perhaps the most important driver of the markets was the near- zero return on risk-free assets such as money markets and short term debt instruments. After very sharp inflows into money market funds post the financial crisis last year, these funds have seen record outflows this year with investors piling mainly into bond funds. Equity mutual funds have reversed their net outflows, and year- to- date through August equity mutual funds have achieved modest net inflows. Even with the rapid outflows, U.S. money market assets still represent approximately 26% of the total market capitalization of the NYSE and NASDAQ. While somewhat reduced, this very large, “mountain” of cash on the sidelines will likely mitigate any sustained correction in the markets, and may provide continued support to the recent rally.

Money Market Assets



Continued on next page ...

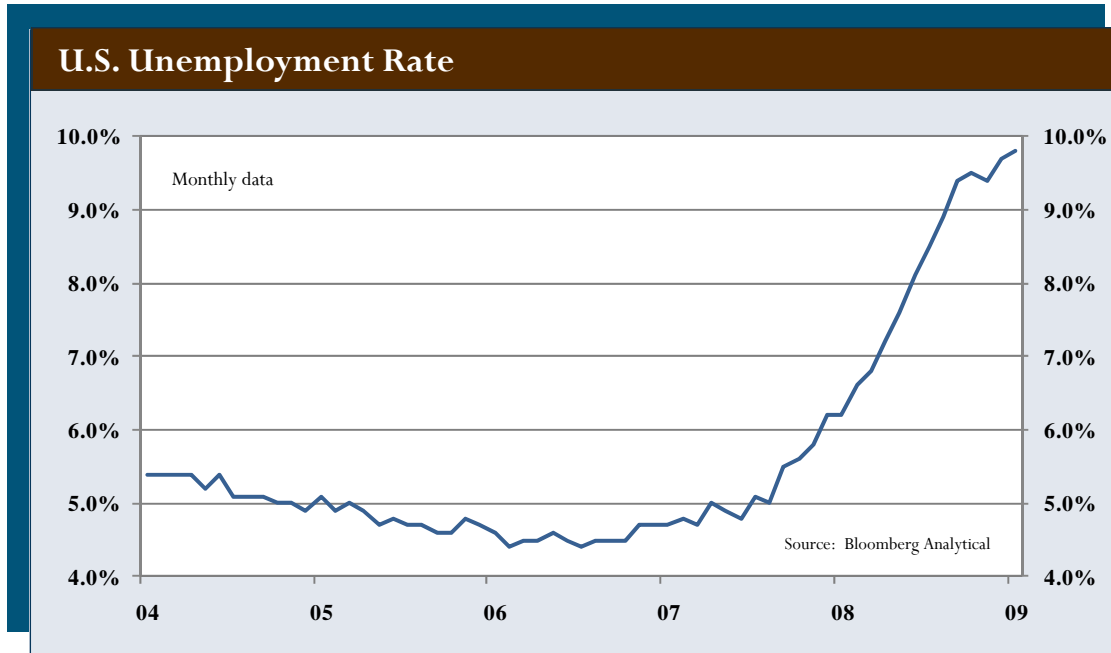
Housing, the primary root of the financial crisis, also showed some improvement in the quarter. The S&P Case-Shiller housing index increased 1.2% in July from the previous month, the biggest increase since October 2005 and the fourth straight month of increasing values. While new home sales were up modestly in August, sales of existing homes registered a surprising decrease. Additionally, the overhang of unsold homes dropped to an 8.5 months supply from 9.3 months due to a sharp reduction in the number of homes for sale. While certain regions of the country may experience continued declines in housing prices, overall the sector appears to be stabilizing.



The U.S. consumer showed signs of life in August, with retail sales up an impressive 2.8% influenced greatly by the “Cash for Clunkers” program. However, ex-auto sales and gasoline purchases, the increase was still 0.6%, the biggest gain in six months. Considerable uncertainty exists over how much consumers will spend versus save during the upcoming holiday season. Given continuing low levels of consumer confidence (the Conference Board Consumer Confidence Index fell to 53.1% in September), most analysts are forecasting flat to very modest retail sales growth for the remainder of the year.

Counterbalancing these somewhat positive trends is continued weakness in the employment outlook. The disappointing September jobs report which showed a decline of 254,000 jobs pushed the unemployment rate to 9.8%, and the underemployment rate, which includes those working part time but desiring full time employment, reached 17%. Furthermore, average weekly earnings over the past year have only increased by 0.7%, less than the cost of living increase as employers have reduced hours worked. While the rate of growth in unemployment has lessened, we continue to estimate that unemployment will edge up over 10%, and that jobless

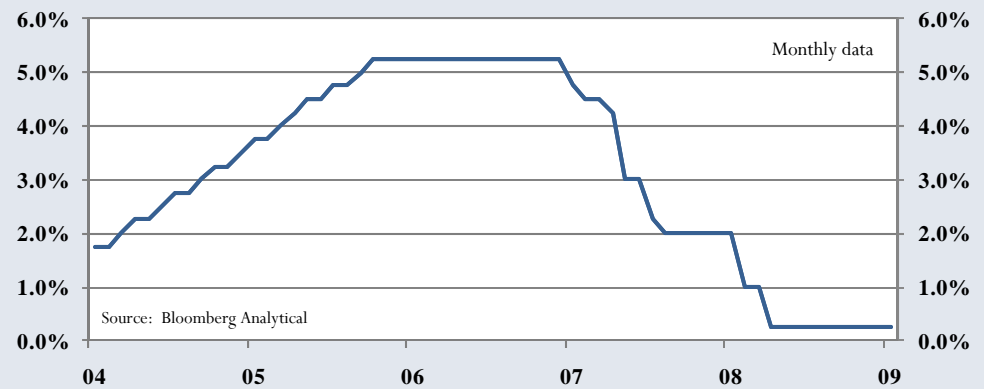
levels will remain high for an extended period. This is due to two main factors: 1) in order to have a stable unemployment rate, the economy must create 100,000 net new jobs a month given population growth, and 2) with the average work week at a low of 33 hours/week as of September, employers can add hours worked to the existing workforce and will be slow to hire new workers until sustained demand is confirmed.



The weak labor market will be front and center of the political debate with mid-term elections just over one year away. Republicans are already claiming that the Obama Administration's stimulus plan was a failure, and the Democratically-controlled Congress will push for more fiscal support in order to retain majority control in the upcoming elections. Ideas currently under discussion include extending and possibly expanding the \$8,000 tax credit for first-time homebuyers, increasing infrastructure spending, and extending the term of unemployment benefits. Given the growing outcry over government spending levels, however, a second major fiscal stimulus bill would appear to be a non-starter politically.

The high level of "slack" in the economy as measured by the unemployment rate and capacity utilization (69.6%) allows regulatory authorities to continue pursuing aggressive monetary policies without the risk of creating near term inflationary pressures. In fact, we continue to be more concerned about deflationary risks in the short term given excess capacity in so many sectors of the economy. Our opinion is that the Fed's and Treasury's "exit strategy" will be implemented very slowly and that the first phase will entail the unwinding of various programs such as the Fed's purchases of mortgages. Increasing the Fed Funds rate is, at the earliest, a second half of 2010 event.

Fed Funds Rate



VAUGHAN NELSON

600 Travis, Suite 6300
Houston, Texas 77002-3071

713.224.2545
888.888.8676
713.228.4292 fax

www.vaughannelson.com

PRESIDENT AND CEO

Lee A. Lahourcade, CFA

EQUITY INVESTMENTS

Dennis Alff, CFA
Margaret M. Buescher, CFA
James R. Eisenman, CPA
Michael J. Hanna
Jeff Sokol, CFA
Chris D. Wallis, CFA
Scott J. Weber, CFA
William C. Wojciechowski, PhD

FIXED INCOME INVESTMENTS

Charles E. Ellis
Blanca L. Garza-Bianco
Steven M. Henriksen

MARKETING/CLIENT SERVICE

Mark E. Farrell
Casey Herren
George C. Holewyne

In summary, we believe that the worst of the financial crisis is behind us and that the economy has turned a corner, but that the recovery will be very sluggish. Our equity strategy during this period has focused on increasing the cyclical exposure of our portfolios in anticipation of a recovery and higher growth rates in the developing economies. But we will be listening closely to company guidance as third quarter earnings are reported, looking for signs that the recovery will be sustainable beyond this inventory replacement cycle. Valuations in the market overall are fair, but we continue to find attractive opportunities, and our companies' superior returns on assets and lower earnings volatility position the portfolios well in the current environment.

Our taxable fixed income portfolios benefited from our overweight position in the investment grade corporate sector during the third quarter. Given the modest economic recovery, and the ever increasing issuance of Treasury securities to finance the expanding deficit, we continue to structure bond portfolios for a rising interest rate environment with shorter durations/maturities, and remain underweight in overvalued Treasuries in favor of Corporate, Mortgage and Agency sectors. Our tax exempt portfolios have benefited from significant fund flows into the municipal markets given near zero returns in money markets. Our research into the "underlying" credit quality of municipal taxing authority issuers enabled us to purchase mispriced bonds over the past several quarters. Within the municipal market, both the yield curve and the credit curve are extremely steep. We believe it is important to maintain an intermediate to shorter average maturity portfolio in anticipation of higher interest rates in 2010.