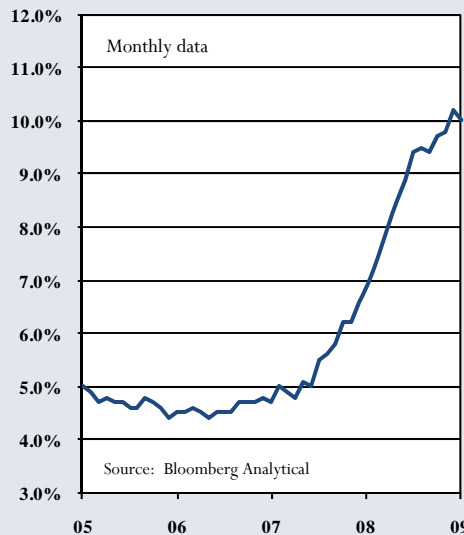




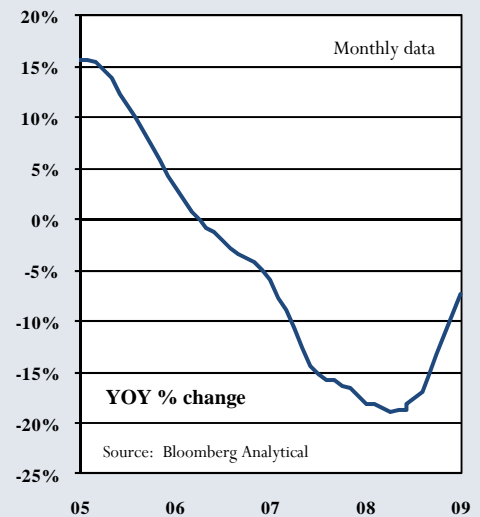
Stocks advanced for the third consecutive quarter with the S&P 500 Index returning 6.0% in the fourth quarter. Equity investors experienced a “white knuckle” rollercoaster ride in 2009 with a drastic decline in the early months of the year, followed by an almost non-stop 65% rally post the March 9 low, resulting in the S&P 500 Index advancing 26.5% for the year. Bond investors had highly variable returns depending on the maturities and sectors of their fixed income investments, as longer term interest rates increased but corporate, mortgage and municipal bonds performed well. Illustrating this variability, the Barclay’s Aggregate Index returned 5.9% in 2009, while the Barclay’s Treasury Index *declined* 3.6% during the year.

Virtually all of the key drivers of the economy and markets discussed in our third quarter *Investment Perspective* remained in place during the fourth quarter, namely highly stimulative monetary and fiscal policies, a near zero return on risk-free assets (e.g. money market funds), still weak but slowly improving employment and housing markets, and the rebuilding of depleted inventories. After a positive 2.2% increase in GDP in the third quarter, and estimated fourth quarter GDP growth in the 4 to 5% range, the recession which began two years ago appears to be over. We concur with the general consensus that a double dip recession is unlikely due to the political pressure to continue stimulative policies given high unemployment levels. In addition, global demand has staged a very solid recovery with China, Brazil and other emerging economies posting high single-digit GDP growth rates. Corporations and consumers are slowly starting to spend again, albeit at much lower rates than in past recoveries given households’ deleveraging trends and financial institutions’ reluctance to lend to anyone but the most credit-worthy borrowers.

Unemployment Rate

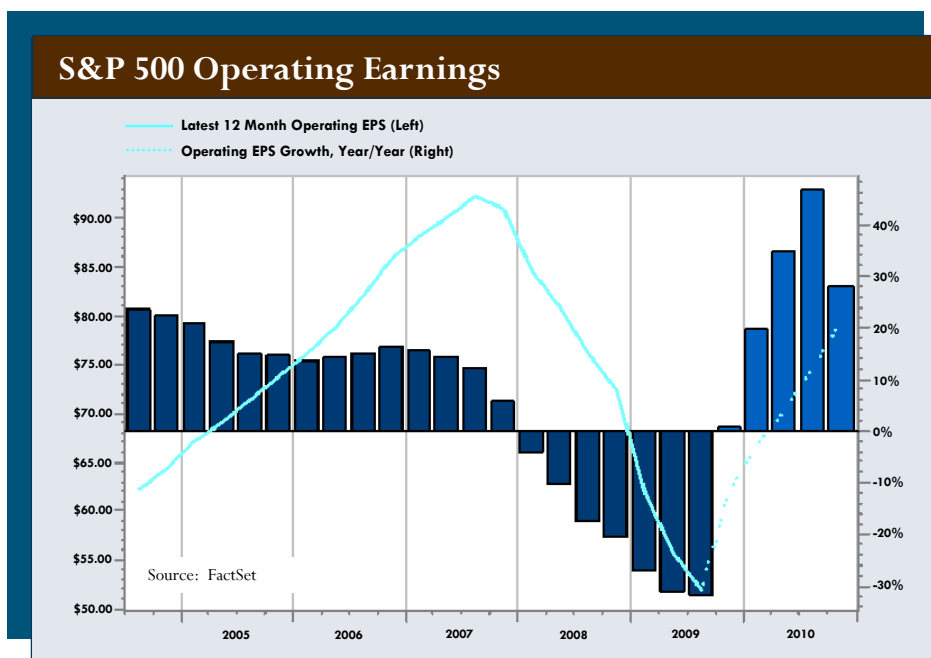


Home Price Appreciation

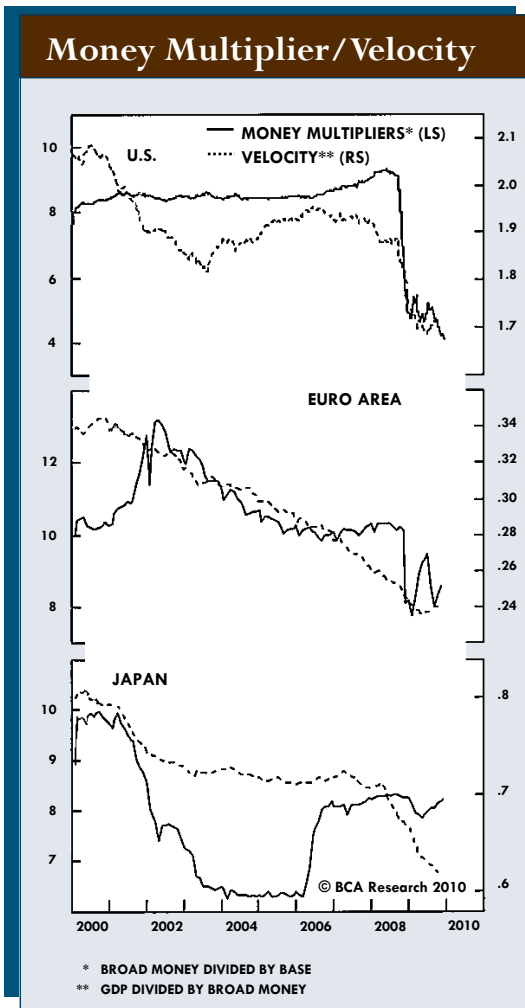


Given the improving economic fundamentals and a highly accommodative Fed, the interest rate yield curve steepened dramatically in 2009. The “flight to safety” to Treasury securities that occurred after the Lehman bankruptcy in the fall of 2008 was reversed in 2009. The yield on the ten-year Treasury rose from 2.2% at the beginning of the year to 3.8% at 12/31/09, while Fed Funds remained near zero. A steep yield curve is a key objective of the Fed as it enables banks and financial institutions to rebuild their reserves in order to withstand future losses (commercial real estate losses are mounting), to be major purchasers of newly issued government debt, and to eventually make new loans.

The near zero risk-free rate orchestrated by the Fed practically “forces” investors to allocate capital to riskier assets such as equities. Given the stock market rise, a nascent positive feedback loop has been created: as asset values increase, consumers are willing to start spending again, which helps to improve corporate profits, which in turn helps to support higher valuations.



The source of this positive feedback loop is of course the unprecedented level of public intervention in the capital markets and economy (e.g. quantitative easing). Essentially, these policies have transferred risk from the private markets to the public sector, not only in the United States but throughout the world. Two specific risks that can result from these highly stimulative policies are sovereign risk and inflation. Markets were temporarily rattled in the fourth quarter over concerns of the excessive debt levels in Dubai, Greece and Ireland, and interest rates in these stressed economies have risen significantly. While the dollar declined in 2009, the huge scale of our economy and our reserve currency status limits any near term sovereign risk to the U.S., but the longer term risk is potentially significant. The structural deficits which appear to be only worsening with pending policy actions such as the healthcare legislation are clearly unsustainable and must be addressed in order to avert longer term economic malaise.



Regarding inflation, once again, its risk is dependent upon the timeframe and future policy actions. Given high levels of “slack” in the economy (high unemployment, low capacity utilization, excess real estate), the near term inflation concerns are quite low, as evidenced by core inflation levels which continue to drift lower in spite of the economic recovery. Another key reason for contained inflation is the very limited bank lending which has resulted in a low money multiplier and low velocity levels. As long as these levels remain benign, Central Banks are able to maintain their accommodative policies without risking inflation, and we estimate that many of these policies will remain in place for most or all of 2010.

As for the longer term risk of inflation, it is our working assumption that policy makers will err on maintaining easy money policies too long, and that a monetization of the public debt is the most likely scenario. It appears unlikely that there will be the political will to reduce spending levels and increase taxes sufficiently to tackle the extremely high budget deficits, and the demographic trends of the developed nations will only compound the problem. It is difficult to forecast when these inflationary pressures will surface, but they are likely to pose serious challenges for investors in the years to come.

Our investment strategy in both equities and fixed income is highly influenced by the generally positive short term trends, but with a careful eye toward the future and the potential for these trends to reverse. In our equity portfolios, we continue to favor high quality, cyclical companies which will benefit from the economic recovery. We have added some attractively valued

financial companies to our portfolios, given enhanced transparency and improving creditworthiness. Overall, the market is reasonably valued given the low level of interest rates, but its continued advance will be dependent upon expected earnings being achieved. Our focus on companies with high returns on capital and lower earnings variability than the market positions us very well at this stage of the market rally.

Our taxable, multi-sector fixed income portfolios benefitted from the historic improvement in investment grade credit risk premiums (spreads) in 2009. We remain bearish on the Treasury market given the likelihood of higher interest rates due to the improving economy and the massive issuance required to fund the growing deficits, and remain positive on the investment grade sector given the improving credit conditions of corporations. We also expect that corporate bond issuance will remain low again this year as corporations generally have record levels of cash on hand and the deleveraging cycle is still underway. Finally, we believe that many bond investors were shocked by the lack of liquidity in the high risk, structured note sector, and will

gravitate back to the very liquid, traditional sectors such as Corporate bonds, Agency Notes and Mortgage pass-through securities. These sectors have a long history and performance record in various economic and interest rate environments, something that the structured asset-backed notes created in the mid 2000's lack. Per our strict adherence to our investment philosophy of seeking relative valuations and providing our clients with attractive *risk-adjusted* returns, we avoided these illiquid securities in 2008 which allowed us to take advantage of mispriced opportunities in 2009.

Tax-exempt bonds provided very solid after- tax, risk- adjusted returns in 2009, and continue to look attractive due to the prospect of higher future tax rates. We continue to structure our Municipal portfolios with the highest quality credits, and with a focus on short to intermediate maturities due to our expectation of gradually rising interest rates.



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