Quarterly Economic Update

March 19, 2013

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

Federal Reserve Chairman Ben Bernanke and the Federal Open Market Committee (FOMC), not satisfied with the pace of employment gains, have continued to support the economic recovery with their non-traditional policy tools and forward rate guidance. While employment has been improving, the pace has not been strong enough to alleviate the concerns of many FOMC members who still see significant downside risks to the economic recovery. The FOMC most recently met in mid-December and late January. The December meeting resulted with the initiation of additional Treasury purchases to replace the scheduled end of the maturity extension program and a change to the FOMC's forward rate guidance.

With the maturity extension program set to expire at the end of 2012, the FOMC announced at their December 12th meeting that upon the program's scheduled completion they would initiate the purchase of $45 billion in longer-term Treasury securities per month. This comes in addition to the open-ended purchase program already announced last September of $40 billion per month in agency mortgage-backed securities. They also announced they would continue reinvesting principal payments from agency debt and mortgage-backed securities holdings into agency mortgage-backed securities and that they would resume rolling over maturing Treasury securities. Chairman Bernanke stated at his press conference following the FOMC meeting, "In continuing its asset purchases, the Committee seeks to maintain downward pressure on longer-term interest rates and to keep financial conditions accommodative, thereby promoting hiring and economic growth while ensuring that inflation over time is close to our two percent objective." The $45 billion per month in Treasury securities will be allocated across the maturity range according to the table below and will have an average duration of roughly nine years.

Nominal Coupon Securities by Maturity Range						TIPS
4 - 4 3/4 Years	4 3/4 - 5 3/4 Years	5 3/4 - 7 Years	7 - 10 Years	10 - 20 Years	20 -30 Years	4 - 30 Years
11%	12%	16%	29%	2%	27%	3%

Source: Federal Reserve Bank of New York

Chairman Bernanke went on to state that the committee "expects to continue asset purchases until we see a substantial improvement in the outlook for the labor market." As with the $40 billion per month agency mortgage-backed securities purchase program, the $45 billion per month Treasury purchase program is also open-ended. The FOMC's intention to leave these purchase programs open-ended versus setting a total dollar amount to be purchased over a specified time horizon is their desire to communicate their willingness to provide support until it translates to an improvement in labor conditions. They also want the focus to be on the stimulus being provided versus the end of the program and the withdrawal of stimulus. The new Treasury purchase program did not necessarily come as a surprise. The $45 billion per month amount simply replaces the amount of longer term securities being purchased as part of the maturity extension program that expired. If the FOMC would have simply let the maturity extension program end without the additional purchases, it would have essentially been seen as removing stimulus from the market and market participants had expected some sort of large scale asset purchases to offset the end of this accommodation. It should be noted that the FOMC statement read that the Treasury purchases will *initially* be made at a pace of $45 billion per month. Chairman Bernanke elaborated in his press conference that "the Committee intends to be flexible in varying the pace of securities purchases in response to information bearing on the outlook or on the perceived benefits and costs of the program." The Committee will use more of a qualitative approach when evaluating the continuation and amount of securities purchases considering a "range of labor market indicators, including the unemployment rate, payroll employment, hours worked, and labor force participation, among others."

The other notable shift at the December meeting was the change in forward rate guidance for the federal funds target rate. The FOMC has held the target range for the federal funds rate at 0 to ¼ percent since December 2008 and has used forward guidance for their expectations on the future path of the federal funds rate as a policy tool in itself. Initially, the forward guidance language used to describe expectations was that the Committee "anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate *for some time*." At the March 2009 meeting, the FOMC, attempting to clarify their commitment to keeping the rate low, reworded their forward guidance language to read ". . . *for an extended period*." At the August 2011 meeting, they introduced the calendar-date guidance that read "*. . . at least through mid-2013*." They later extended the date to "*at least through late 2014*" at the January 2012 meeting and again to "*at least mid-2015*" at the September 2012 meeting. The December meeting represented a new shift in communication strategies for the FOMC around forward rate guidance when they discontinued the calendar-date guidance and introduced quantitative unemployment rate and inflation thresholds. The forward rate guidance from the December FOMC statement read that the Committee "anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6 ½ percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." The shift from a calendar date to quantitative thresholds had been discussed among FOMC members at several recent meetings and these discussions had been documented in the FOMC minutes, however these discussions seemed to be in the early versus late stages of discussion and the December announcement took most market participants by surprise.

Chairman Bernanke devoted a great deal of time in his press conference to discuss this change in forward rate guidance to clarify the Committee's goals in using the new language and how market participants should interpret the statement. He explained the reasoning behind the change as "The modified formulation makes more explicit the FOMC's intention to maintain accommodation as long as needed to promote a stronger economic recovery in the context of price stability, a strategy that we believe will help support household and business confidence and spending. By tying future monetary policy more explicitly to economic conditions, this formulation of our policy guidance should also make monetary policy more transparent and predictable to the public." Chairman Bernanke made an effort to emphasize that the change in forward guidance did not represent a change in policy or the Committee's expectations on the timing of future rate increases. He also highlighted that the 6 ½ percent unemployment rate threshold should not be confused with the FOMC's long-run target.

Chairman Bernanke stressed four points regarding how the FOMC would use these thresholds, how they should be viewed by market participants, and how the change in guidance should not be viewed as placing monetary policy on autopilot. First, the unemployment and inflation thresholds are not trigger points that would result in an automatic change to the federal funds rate target. The Committee simply expects its current target range for the rate to be appropriate at least until these thresholds are met. Second, the Committee will consider changes in the unemployment rate within the broader context of labor market conditions. Drivers of a decline in unemployment and the sustainability of a declining trend will be considered. They acknowledge that the unemployment rate as a single indicator viewed in a vacuum cannot provide an accurate assessment of the labor market by itself. Third, the Committee is looking at projected inflation out one to two years, not current inflation that may be driven by transitory items. Fourth, the Committee will ensure that policy is conducted in a manner consistent with the FOMC's dual mandate of maximum employment and price stability.

The January 30th FOMC meeting was uneventful with no additional change to monetary policy. Chairman Bernanke presented his Semiannual Monetary Report to the Congress on February 26th, which was also uneventful, but contained an interesting commentary on the cost-benefit framework that Bernanke and the FOMC use to assess the large scale asset purchase programs. The benefits are fairly self-evident. Chairman Bernanke described these benefits in his testimony, "Keeping longer-term interest rates low has helped spark recovery in the housing market and led to increased sales and production of automobiles and other durable goods. By raising employment and household wealth—for example, through higher home prices—these developments have in turn supported consumer sentiment and spending." When discussing the potential costs to large scale asset purchases, he highlighted that there is risk that purchase programs could lead to a deterioration in market functioning or liquidity in markets where the Federal Reserve is buying securities if they become such a large buyer that it affects liquidity and price discovery among private participants. Another potential cost is that additional purchases could lead market participants to question the Federal Reserve's ability to exit its accommodative policy when it does become necessary to tighten policy causing inflation expectations to become unanchored. A third potential cost is that these programs could lead to excessive risk taking by investors creating instability in certain financial markets. While Bernanke acknowledges these costs are important concerns that should be continuously assessed, he believes the current benefits of large scale asset purchases outweigh the risks and that the FOMC has the ability to monitor these risks and also has the tools to address these risks should they increase.

A change to the federal funds target rate should be fairly transparent now that the FOMC has introduced its quantitative thresholds. Market participants are not likely to anticipate any change in the near term until we begin to see significant progress towards reaching the 6 ½ percent unemployment rate threshold or longer-term inflation trending above 2 ½ percent. As new information and data is received on these thresholds, market participants can adjust their expectations for tighter monetary policy through the federal funds target rate. There will likely continue to be speculation from meeting to meeting on the large scale securities purchase programs. The FOMC has said they took into account more qualitative information on the labor market when considering the pace and continuation of securities purchases. They have also communicated their intentions to be more flexible with the pace of purchases, so market participants are certain to speculate on purchases going forward as they evaluate economic and labor market data. The FOMC will likely discontinue securities purchases long before they begin raising the federal funds target rate. The questions of how long they continue purchases, whether the next move is to increase the pace of purchases or decrease the pace of purchases remain unknown. They have maintained that both increasing and decreasing purchase amounts are options that remain on the table. Chairman Bernanke has also stated that a decision to end asset purchases should not be viewed as a shift to tighter policy, and that policy would still remain highly supportive of growth even after purchases are discontinued. Chairman Bernanke and the FOMC as a whole continue to express their disappointment in the pace of employment and their commitment to provide support to financial conditions that foster economic growth and employment gains, maintaining that inflation remains subdued and seemingly placing greater focus over the near term on the maximum employment portion of their dual mandate.

Fiscal Policy

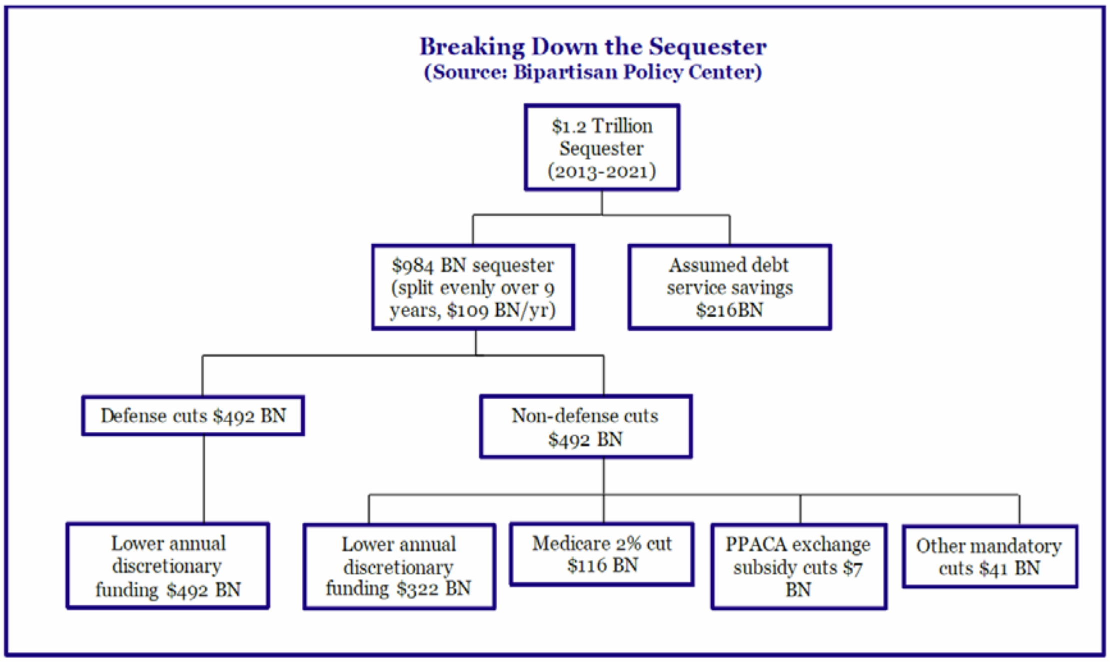
By Michael McNair

Over the past couple of years fiscal policy has become an increasingly hot topic. The current political environment is highly polarized and the main battleground is now centered on fiscal policy. The two parties currently have widely divergent ideological views on the role of government in the economy, which has caused every budgetary vote to flare up into a major conflict that threatens the confidence of American citizens and the capital markets. From the debt ceiling to the fiscal cliff and now sequestration, the public is constantly being bombarded with a new crisis and terminology that the issues have been difficult to follow. We hope to summarize the recent developments concerning fiscal policy in the United States and forecast how the battles in Washington will impact future economic growth.

The origin of the sequester goes back to the summer of 2011 when the US was approaching the debt ceiling. The debt ceiling is a self-imposed limit on the amount of debt the US government is allowed to issue. As you may recall, in order to get Democrats to agree to future spending cuts congressional Republicans threatened to force the nation into a technical default by not allowing the federal government to borrow the money necessary to pay for the spending that Congress itself had already approved. At the last minute a deal was reached where the Republicans agreed to lift the debt ceiling in return for an agreement to cut future government spending in two ways. The first part of the spending cuts came from a cap on future discretionary spending. Discretionary spending is essentially any government spending that are not for entitlements (entitlements include Social Security, Medicare, Medicade, food stamps, etc…). Secondly, Congress set up a bipartisan supercommittee that was charged with the task of finding ways to reduce the deficit by an additional $1.2 trillion. If the committee failed to reach an agreement on how to cut over a trillion dollars from the federal deficit, a sequester would kick in that automatically cut $109 billion a year in federal spending for the next 9 years. In order to motivate the bipartisan committee to reach an agreement, these cuts were set up to be divided equally between military spending (a Republican priority) and domestic spending (a Democratic priority). The thought was that the cuts from the sequester would be so severe to these vital issues for each party that they would be compelled to find other ways to reduce the deficit that would not be so draconian. Despite the consequences, the supercommittee failed to reach an agreement and instead the sequester was scheduled to begin on January 2, 2013.

A year after the debt ceiling debacle the nation faced yet another major fiscal policy crisis: the fiscal cliff. Since the Bush tax cuts nearly a decade ago, much of the United States tax policy has operated under temporary measures that require Congress to annually extend certain tax measures. Typically these tax cuts were extended rather easily; however, the inflating cost of these tax measures and the growing political divisiveness in Washington, evident in the debt ceiling debate, made it clear this ideological battle over the direction of fiscal policy would come to a head with the decision to extend these tax provisions for 2013. The crisis became known as the “fiscal cliff” because absent an agreement to extend these measures, the size of the tax increases set to hit in 2013 amounted to 4% of GDP. Once again, Congress waited until the last minute to finally reach an agreement but only to partially avoid the fiscal cliff. Congress agreed to extend just over 80% of the expiring tax cuts which turned the fiscal cliff into a fiscal slope. While the worst outcome was averted, the $620 billion of tax increases that were allowed to pass and the considerable amount of uncertainty caused by the fiscal cliff negotiations will be a certain drag on the country's economic growth.

The fiscal cliff deal also pushed the time table for the start of the sequester from January 2, 2013 to March 1, 2013 in hopes that it would give the two parties time to come up with a way to avoid the sequester. As we mentioned earlier, the sequester is the automatic spending cuts to defense and domestic discretionary spending that are a result of the failure of the supercommittee to reach an agreement in the debt ceiling negotiations. The breakdown is shown in the chart below:



Source: Strategas

In order to avoid the cuts to these two programs, Congress had to offset the spending by replacing these cuts with reduced expenditures elsewhere in the budget, raise taxes, or some combination of the two. The Democrats refused to make cuts to entitlement spending and therefore forced the Republicans to decide between their two worst fears: raising taxes or cutting defense spending. After the agreement to avert the fiscal cliff resulted in over $600 billion in tax increases without the Democrats conceding a single dollar of spending cuts, the Republicans refused further tax increases and decided to prioritize spending cuts even if it was at the expense of one of their most important agendas. Therefore, despite each party seeming to have ample motivation to avoid the drastic cuts to two vital programs for the respective constituents, the deadline to reach an agreement has passed without Congress taking action and the sequester officially kicked in on March 1st.

Fiscal Policy's Economic Drag

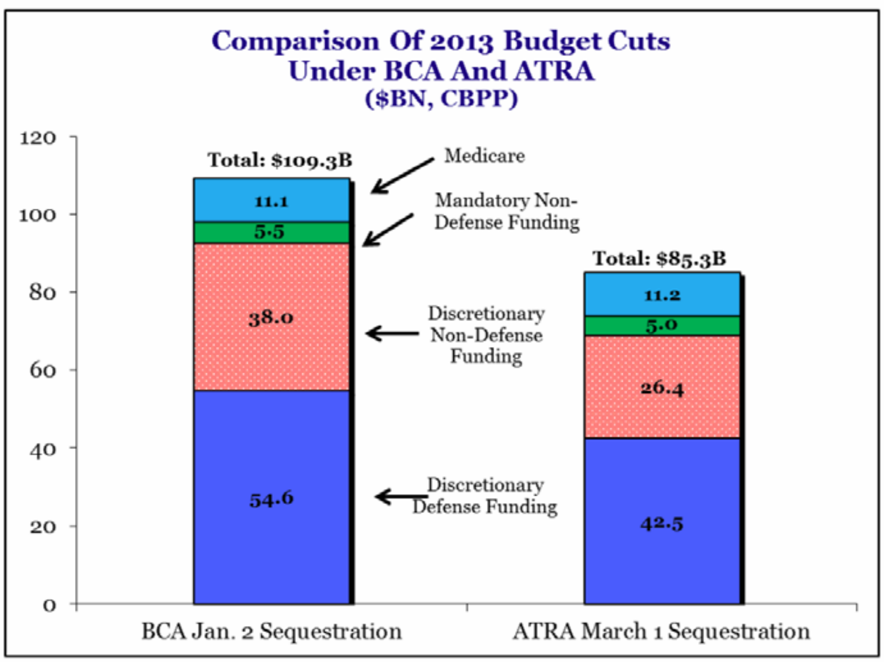
It is important to reiterate that the 2011 debt ceiling agreement actually created two components to the sequester. The first part of the sequester, called the "penalty sequester", refers to the $109 billion of spending cuts that will occur annually for the next 9 years. $54.6 billion of the cuts are to come from defense spending while $38 billion comes from discretionary non-defense spending and the remaining $16.6 billion comes from cuts to entitlement programs.

The second part of the sequester is a result of the agreement to cap future discretionary spending at a level that will cut $1.1 trillion in spending over the next 9 years. Under this provision, if discretionary spending exceeds the stated cap during a given year, an "after-session" sequester kicks in that automatically reduces the next year's spending by the equivalent amount. Over the previous year discretionary spending exceeded the cap; therefore, the "after-session" sequester will be enforced on March 27th, 2013.

As we have previously stated, the US economy originally faced a combination of spending cuts and tax increases in 2013 that would have amounted to over 4% of GDP and would have certainly put the US economy back into a recession. However, the fiscal cliff negotiations did two things: 1) it extended 82% of the tax cuts set to expire and 2) it slightly modified sequestration and moved the start date back from January to March.

This lowered the "penalty" sequestration cuts for 2013 from $109 to $85.3 billion:

FISCAL CLIFF DEAL LOWERED THE AMOUNT OF REQUIRED SEQUESTRATION BUDGET SAVINGS IN 2013

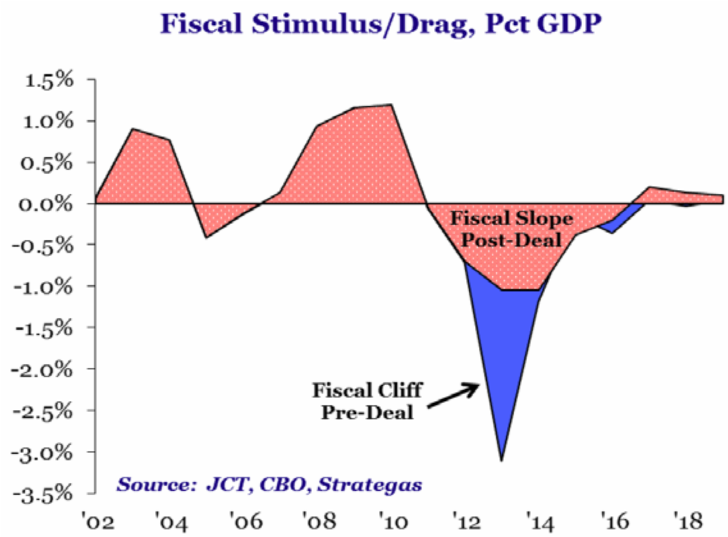


Source: Strategas

BCA – Budget Control Act of 2011: Mandated sequestration starting 1/2/13

ATRA – American Taxpayer Relief Act of 2012: Mandated a modified sequestration and pushed the starting date to 3/1/13

As a result of the fiscal cliff deal, the drag on economic growth from the tightening of fiscal policy has been greatly reduced for 2013. Dan Clifton of Strategas Research estimates that the fiscal drag will now take off 1.3% from US GDP this year as a result of "…the expiration of the payroll tax cut, tax increases on upper income taxpayers for income, capital gains, and dividends, as well as the revised sequester spending amounts from the fiscal cliff deal." His revised estimates are shown below:



We caution that any forecast on fiscal policy's effect on the economy is highly sensitive to the tax and spending multipliers used in the calculation. Economists have differing opinions on the size of the multipliers but in reality these multipliers are not static but instead depend on the state of the economy. When private sector demand is weak, government spending will have a higher multiplier than when private sector demand is strong. With housing having finally bottomed and inflation low, private sector demand is getting stronger. However, if inflation were to rise through the year and housing falter, the fiscal multipliers will become larger and the tightening fiscal policy will subtract more from growth than our current estimate. In which case, the combination of austerity and decelerating private sector demand would threaten to push the US back into a recession.

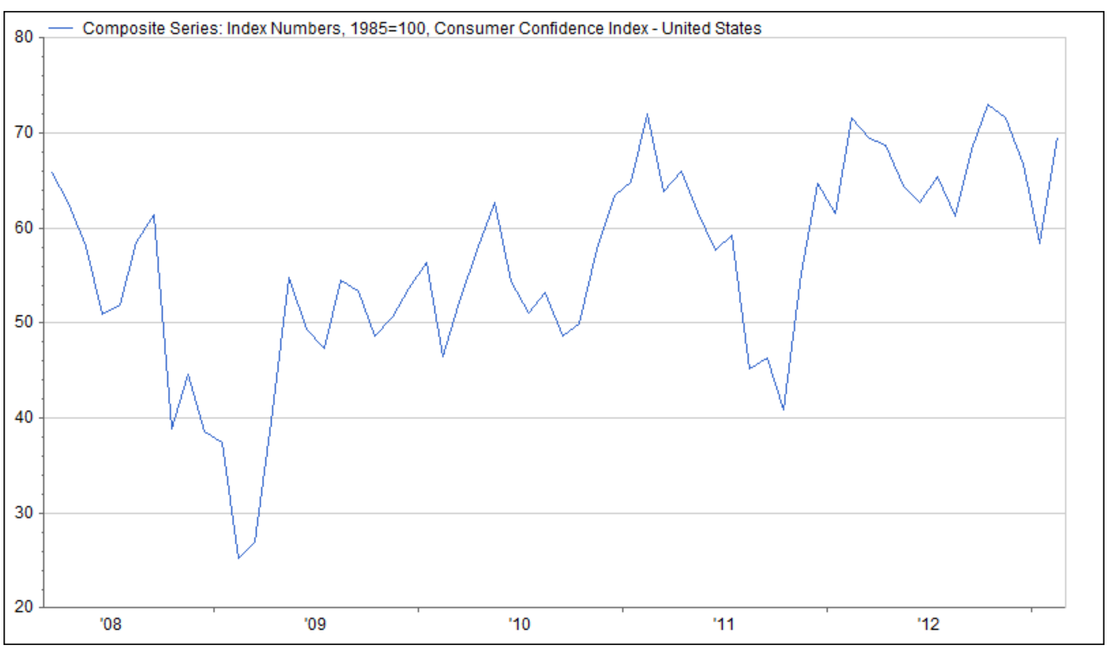
Economic Outlook

By Allan Carr

Economic data has been extremely robust of late and as of this writing we have seen over a three week streak of broad based strength in economic releases which points to a strong quarter. While certainly welcome news, this is not the first time we have seen this in recent years. So as we look beyond the first quarter of 2013 the question is will we see a repeat of the last three years where the economy comes out of the gate strong only to witness a summer slowdown? Or will this year be different and the economy keep chugging along?

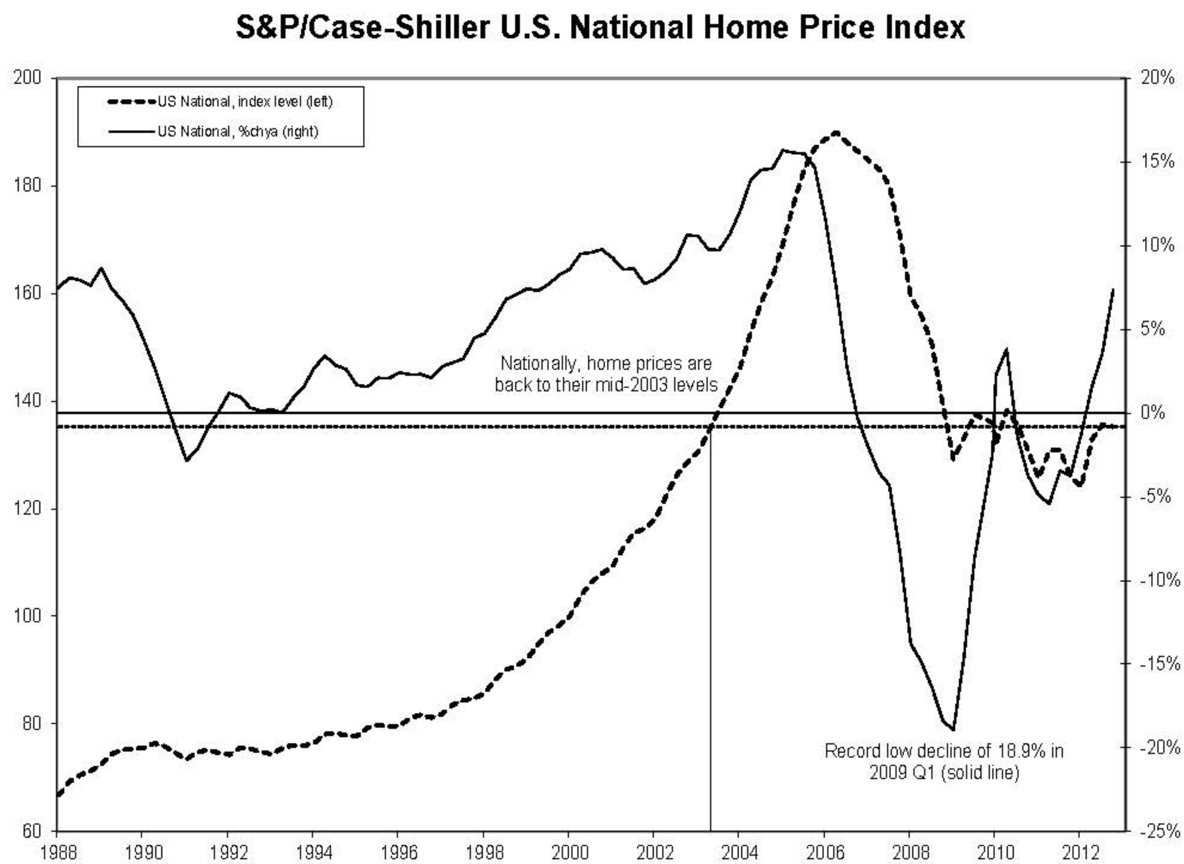
On the business/manufacturing side, the most recent durable goods orders ex-transportation surprised to the upside, followed a few days later with strong PMI numbers. February ISM beat expectations coming in at 54.2 versus economist estimates of 52.5. Looking ahead it was also positive in that the beat was primarily due to the new orders component being up 4.5%. This was the highest ISM manufacturing reading since June 2011. Corroborating the confidence from purchasing managers, both the Chicago Purchasing Managers and New York ISM surprised to the upside on new orders and outlook, respectively. We also saw the highest business inventory reading since May 2011 as companies restock and build inventory in anticipation of higher demand. And lastly, the NFIB Small Business Optimism Index posted its third consecutive monthly increase.

On the consumer side, consumer confidence had its largest monthly improvement since November 2011 jumping 11 points and erasing the nearly 15 point slide witnessed from October through January as the fiscal cliff debate dominated news. The “expectations” component of the confidence release saw a sharp increase and the expectations for jobs and income was more positive. The graph below shows the 5 year consumer confidence index.



A big fear coming into 2013 was the effect tax hikes, mostly the FICA tax holiday expiration, would have on spending as it is estimated to hit consumers' wallets to the tune of $200 billion and hamper GDP by roughly 1%. While there could possibly be a delayed effect, to this point the data has been surprisingly robust both from company reports as well as economic reports. The retail sales report on March 13 beat estimates even with one fewer selling days from the February leap year in 2012. Retail sales were up 1.1% month on month and 4.6% year on year, which points to higher consumer spending than expected. There have been a host of companies reporting more resilient sales including Home Depot posting its strongest same-store-sales gain since first quarter 2004 from the strength surrounding housing.

Housing has been a bright spot for the economy and the outlook continues to improve. On March 8, the Case Shiller data released for year end 2012 came in better than expected. The report showed that nationwide house prices were up 7.3% for the twelve months ended December 2012. This was the largest year over year gain since the June 2006 report near the height of the bubble. The chart below shows the U.S. National Home Price Index annual returns (solid line, right axis) as well as the indexed levels (dotted line, left axis).



Source: S&P Dow Jones Indices and Fiserv

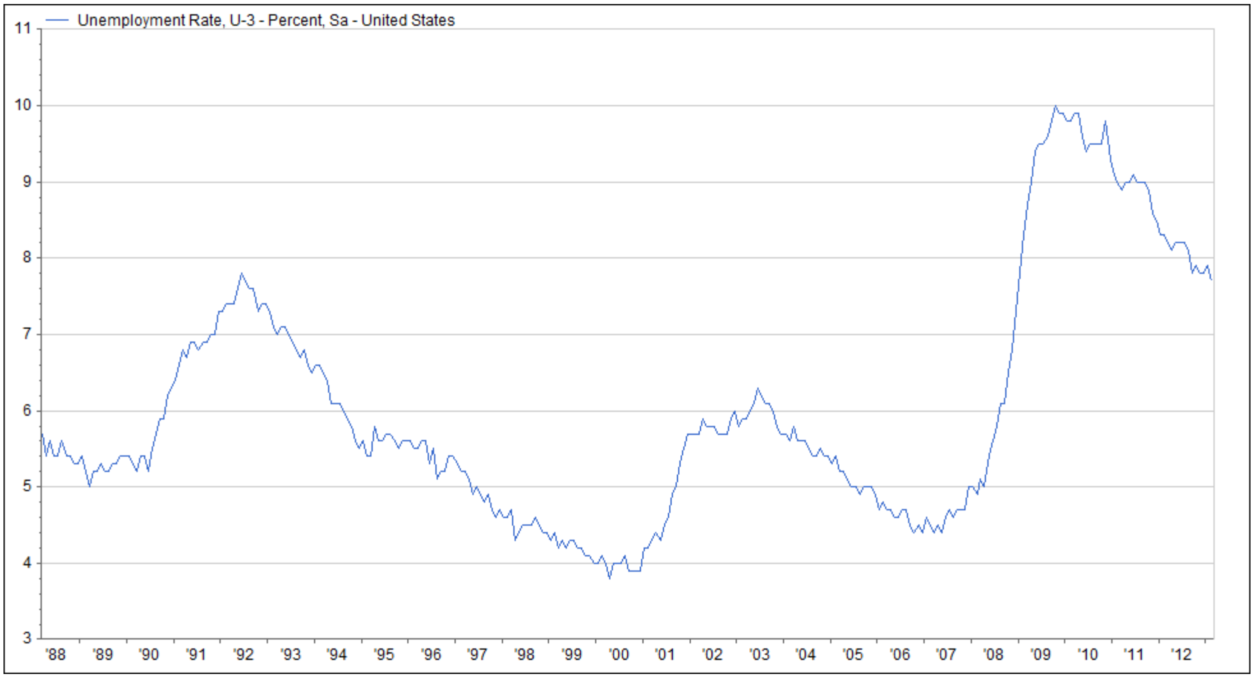
As of the end of 2012, nationwide house prices were back to where they were in the fall of 2003. According to the report, the top 20 MSAs were down approximately 30% from the peak in 2006 and up roughly 8-9% above the lows in March 2012. As a note, the Case Shiller data is calculated as a 3 month moving average with a two month lag so the data is a bit stale. Real time estimates from research firms have prices somewhere in the neighborhood of 15% above the lows from late 2011.

On top of prices rising, new home sales for January were robust, posting a 15.6% increase from December and almost 29% year over year. The Census Bureau's report also stated that there is only a 4.1 month supply of new homes for sale at the end of January, which is the lowest supply measure since 2005. Foreclosure and delinquency data continues to markedly improve with delinquencies at four year lows, and the most recent single-family housing starts number was the highest level since mid-2008. All these datapoints are encouraging and point to a sustainable recovery given the constructive backdrop with rates, affordability, etc.

A beneficiary of the housing turnaround has been new jobs as witnessed by the healthy February employment report. Nonfarm payrolls came in at 236,000 versus estimates of 165,000. Private payrolls rose 246,000 while government jobs fell 10,000. The US economy has now added back over five million jobs in the last three years. The strength was broad based with notable positive month over month changes of 73,000 in professional & business services, 48,000 in construction, and 24,000 in both retail and leisure & hospitality. The retail sector has now seen eight consecutive months of job gains of an average of 28,000. This with retail sales and recent company data shows the resiliency of the consumer to spend even in the face of increased taxes.

Construction has now seen nine consecutive months of improvement and builders have added over 150,000 jobs in the last five months. Housing related jobs were nearly a quarter of the almost nine million jobs lost during the financial crisis, and until recently, the absence of these jobs returning has been a big reason jobs have lagged. Momentum here is encouraging and there is plenty of room left. While we obviously won't return to the number of jobs we had during the peak of housing, for perspective there would need to be roughly another million construction jobs added to get back to where we were in the beginning of 2003 according to a CNN report. There have also been roughly 13,500 people hired in real estate over the last three months, the most in seven years.

In conjunction, the Bureau of Labor Statistics reported the unemployment rate fell to 7.7%, the lowest it has been since December 2008 and down from a peak of 10% in October of 2009 as seen in the chart on the following page.



The fall in the unemployment rate was a combination of stronger than expected hiring as well as a lower participation rate which fell to 63.5%. Back in December, Bernanke and the Fed made it clear that job creation was their primary focus and targeted a 6.5% rate as their goal. According to Morgan Stanley, if the participation rate stays at 63.5%, it would take adding 200,000 jobs per month to get us to 6.5% by October 2014.

While the employment data is encouraging, there is some trepidation that this could be a head fake like we saw in early 2011 and 2012 where payroll numbers started the year strong only to witness a slowdown in the summer months as growth paused. While it certainly can happen again and it's too early to tell, there are several reasons why 2013 could buck the trend. As discussed, housing related strength is a major plus this year versus prior years. Another factor is the trend in unemployment claims which would suggest that job gains should remain healthier. The chart below shows the weekly jobless claims for the last ten years.

Unemployment claims thus far in 2013 are averaging right at 350,000 with the latest weekly reading at 332,000. The latest monthly average was a five year low commensurate with the unemployment rate reaching a four year low. Historically, claims in this range result in job gains in the 200,000 plus range. If claims remain at these levels the odds go down of another summer slowdown in the economy and jobs.

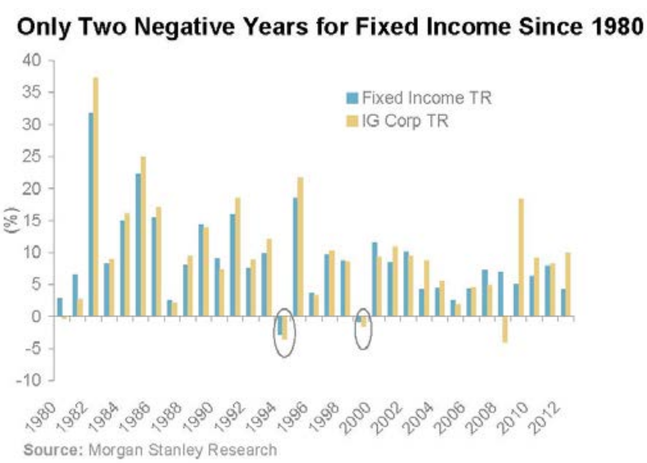
Given all the recent data, it appears the economy is doing better than expected to start the year and that GDP estimates for the first quarter and first half of around 2% have upside potential. We have numerous things going the economy's way: open ended quantitative easing from the Fed, oil prices below last year's level, housing and jobs feeding off each year, the consumer not retrenching from tax hikes, the market continuing its climb, and inflation still in check. With this type of environment it seems that the economy is better equipped to break the midyear growth hiccup of the last three years. However we are just over two months in so we will have to wait and see.

Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last meeting, the calendar year was coming to an end with the election behind us and the fiscal cliff quickly approaching. Government yields rose during most of December before giving up approximately 10 basis points in the last week and a half on little volume. As the case most every year, little business is conducted, especially on the corporate new issue front, during the holiday season. The fund did take advantage of a few opportunities during this down time. The fund was able to add to its position of mortgage-backed securities as MBS spreads had widened from their September tights. Spreads in the sector had tightened dramatically during September in response to the Federal Reserve's quantitative easing program. The initiative has it purchasing an additional $40bn per month in agency mortgage-backed securities. The fund was also able to establish a position in Freeport- McMoRan after the company announced its intention of purchasing oil and gas assets. Spreads in the name widened roughly 60-65bps on the news and allowed the fund to pick up good yield in a company with a strong balance sheet and cash flow generation. Spread product across all sectors outperformed treasuries during the month of December.

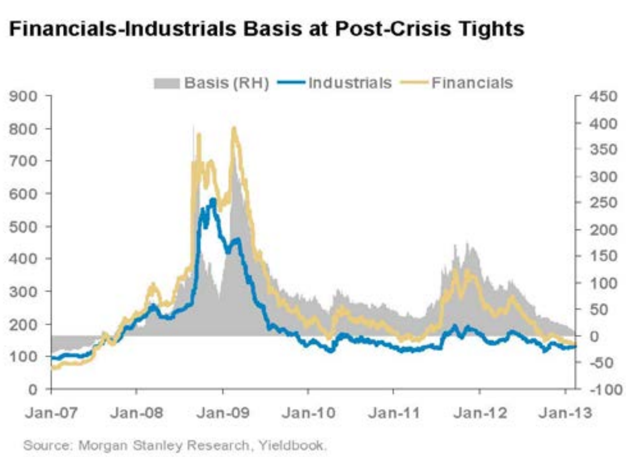
Interest rates continued to increase into the new year, with the 10yr treasury hitting 2% for the first time since last April. This upward move was in response to the release of better economic data and a favorable solution to the major parts of the fiscal cliff. The risk-on environment produced a more than 5% return in equities and a decent return in the high-yield market. Once again, the fund looked to take advantage of name-specific issues in the corporate fixed income market. The fund participated in the new 10yr issued by ADT Corp., a business that controls roughly a quarter of the security business. The company's spreads had widened as hedge fund investors demanded more return on their equity. ADT agreed to a $2bn share repurchase plan funded through debt issuance and free cash. The fund was able to purchase this issue at a 220bp concession to comparable treasuries in a name that provides 90% recurring revenue and has no debt maturities over the next three years. The fund was also able to pick up an additional 60bps by going down in the capital structure in front-end Citigroup



paper. The senior-subordinated relationship has continued to collapse since this trade and is now roughly 40bps in the 10yr part of the curve. In the other sectors, the fund swapped out of a short agency note, providing little to no yield, and into a 15yr Fannie Mae mortgage, picking up approximately 95bps while adding little extension risk. Agency and mortgage-backed securities outperformed during the month, with corporates essentially flat relative to treasuries. Financials, in what has now become a monthly occurrence, outgained its industrial and utility brethren. Corporate supply in January was fairly robust, reaching approximately $115bn in high grade issuance.

The month of February provided a brief pause in the higher-trending 10yr treasury yield from its lows of early December. Rising political risks in Europe, magnified by the Italian election results, tempered investors' optimism. Investment grade debt marginally outperformed government securities during the month. The positive total return performance was mainly rate-driven as there was negligible spread movement. Agency and mortgage-backed securities underperformed slightly due to their smaller interest rate sensitivities. The fund, once again, sold a short agency security with little yield and purchased a 5yr callable note. Within mortgages, dislocations in the market allowed the fund to swap into a mortgage pool with a smaller average loan size limiting prepayment risk if rates were to fall. The fund also participated in the new issue marketed for Freeport-McMoRan to fund the acquisitions the company announced in December. The fixed income staff made the decision to slightly extend duration within the treasury sector. While the fund is underweight this asset relative to its peers, it carries a longer duration bucket of treasury securities. The fund is relatively well positioned in a rising rate environment with lower interest rate sensitivity as a whole. However, it is necessary to have some protection should the economy stumble and a rush to safety ensues.

During his semiannual congressional testimony a couple of weeks ago, Federal Reserve Chairman Ben Bernanke succeeded at calming investors' fears that quantitative easing (QE) was at risk of slowing down in the near future. In December, policymakers added to its $40bn monthly purchases of mortgage-backed securities with a $45bn monthly treasury program. He noted the benefits of current policies in helping the housing market and consumer spending. Since that time, treasury yields have reversed course and resumed their march



upwards. So far this month, trading activity within the fund has been somewhat light. The fund enacted a treasury swap, extending nine months in the intermediate part of the curve in order to pick up approximately 20bps. The fund has also reinvested mortgage prepayments back into this sector given the recent back up in rates. It has been pretty stagnant on the new issue front as the fund is fairly comfortable in its overweight position in corporates and new issue concessions have been non-existent. Despite last week's robust labor report, the fund believes that the Federal Reserve is not inclined to take its foot off the gas pedal just yet. There are too many uncertainties globally and with the Fed's preferred inflation gauge increasing at the slowest rate since October 2009, there is little push back from the inflation hawks at this time.

It is noteworthy to mention that we are now in the midst of a 33-year bull market in fixed income. This run has produced high single-digit returns annually with only two years of negative performance. Over the last 18 months, financial spreads have slowly but surely tightened back to levels not witnessed since the financial crisis. With low bond yields, decent earnings, and clean balance sheets, mergers and acquisitions have started to heat up again. This is a potential risk to corporate debt market considering where spread levels are currently trading. As of this writing, domestic fixed income has returned less than .40% fiscal year-to-date. The point of these statements is to relay that returns and opportunities within the fixed income market are becoming elusive and harder to come by without substantially raising the risk profile.

Domestic Equity Strategy

By Kevin Gamble

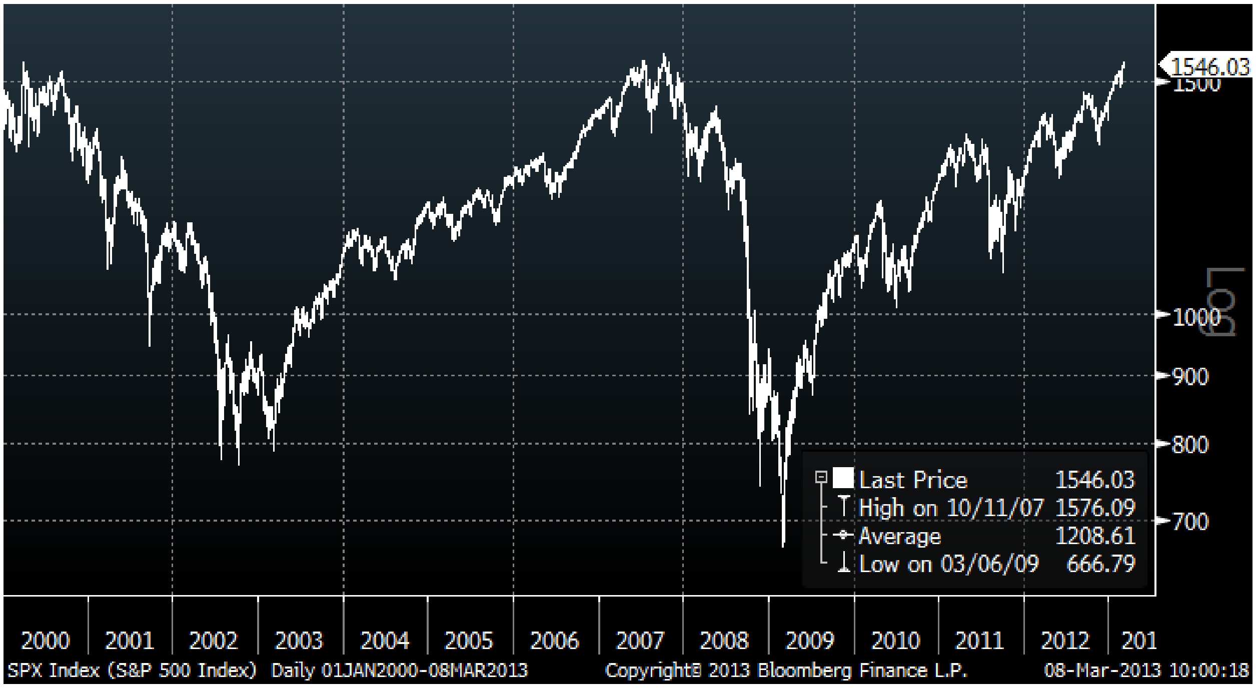
After six years of a wild ride, the Dow Jones Industrial Average finally surpassed its record high of 14,198 set on October 11, 2007. We should all be thankful for this fact given the financial crisis which struck our markets in 2008. The chart below takes a look at the movement of the DJIA this century.

Chart 1: DJIA Since 2000

Source: Bloomberg

While the Dow Jones Industrial Average (megacap, concentrated, price-weighted index) has managed to make a new high, the S&P 500 currently rests just short of its all-time high of 1576 set on the very last day of 2007. Ideally for the equity market bulls this index will push forward and confirm the new highs in the DJIA. The following chart below takes a look at the movement of the S&P 500 index this century.

Chart 2: S&P 500 Since 2000

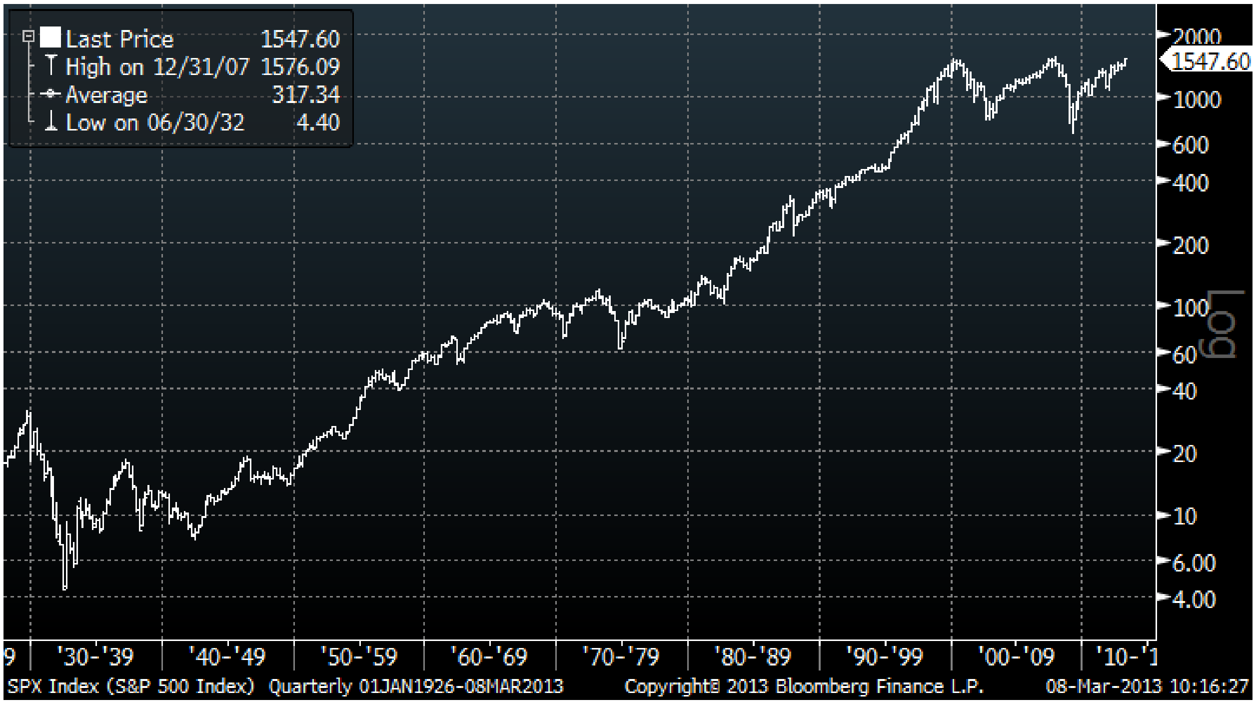


Source: Bloomberg

What is the Big Picture for US Equities? Stuck at the Crossroads of a Cyclical Bull and a Secular Bear

The cyclical bull in US equities is now exactly four years old since bottoming in March of 2009 at 666 of all levels. The range from the high to the low in this period spans a whopping 910 SPX points. Despite this wide range, the market itself has gone absolutely nowhere for over 12 years now (thus a secular bear). Have we seen these type periods in our nation's past? Sure. The following chart takes a look at the S&P 500 index from the peak of the Roaring 1920s market to today.

Chart 3: S&P 500 Since Peak of Roaring 1920s market



Source: Bloomberg

The cost adjusted price of the S&P 500 at the end of June of 1932 during the midst of the Great Depression was 4.4, today it stands at over 1500! Despite this, the period of time from 1929 to 1954 was flat and the period from 1966 to 1982 was flat. Today we are sitting at the top end of the range of another one of these flat periods. We are essentially at the crossroads of a cyclical bull which has been in place for four years and a secular bear which has been in place for twelve years. What is an equity investor to do? What about these low rates? Is this a sucker's rally? Have we fixed anything or have we simply put Humpty Dumpty back together with the same formula that pushed him over the ledge? Is Bernanke more powerful than all the king's horses and all the king's men? Better yet, are we in a situation like 1982 in which we are breaking higher out of a long base never to see these levels again? I think all of these questions are going through an institutional asset allocator's head at this point in time.

In order to begin assessing these relevant questions, I think it is helpful to take a look at a few things side by side in order to compare where we were prior to the financial crisis to the crossroads we find ourselves at today.

Chart 4: Then Versus Now – The Alpha and the Omega of a Financial Crisis?

		SPX Peak (Oct. '07)		Current		% Change
S&P 500 Level		1565.15		1549		-1%
10-year Treasury Yield (%)		4.6%		2%		-57%
Spot Gold Price ($/oz.)		738		1578		114%
Unemployment Rate		4.7%		7.7%		64%
Nominal GDP Level ($Bn)		$ 14,126		$ 15,851		12%
National Debt ($Bn)		$ 9,079		$ 16,687		84%
Fed Balance Sheet Assets ($Bn)		$ 859		$ 3,104		261%
Number of Food Stamp Beneficiaries		26,316,000		47,692,896		81%

Source: Strategas

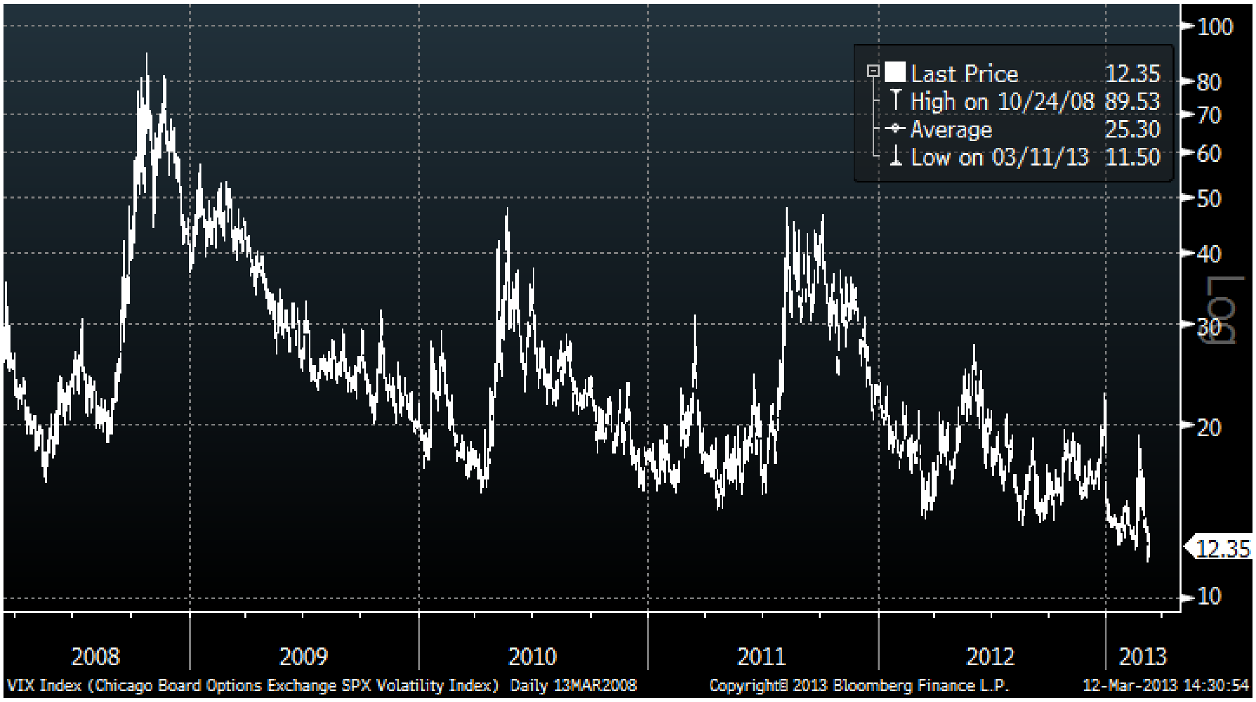
When comparing the two periods, it is pretty clear to see what has helped to bring the nominal levels of the market back to Kansas if you will. Interest rates have fallen 57% allowing borrowers to refinance and/or simply reduce their payments or pay down their debt at a faster rate, the price of gold has more than doubled indicating a level of nominal reflation of the currency, the national debt is 84% higher than it was at the peak so Keynesian expansionary fiscal policy/spending has contributed to the reflation, and perhaps most importantly the Federal Reserve has expanded its balance sheet by 261% to over $3 trillion dollars. While the stock market has made its way back to previous levels, clearly this has come at a price to society as the number of food stamp beneficiaries is 81% higher than in 2007 and the debt load for the country has almost doubled which will come at a future price.

At the height of the financial crisis, the call from everyone was to revive the patient by any means necessary and then see if he/she can live on its own once revived. I think in many ways the patient has been revived through both aggressive monetary and fiscal policy and we will now get to see if the economy and equity markets can function normally from this point forward. The true success or failure of the policies employed over the last few years is still to be determined in the future as we have not yet had to pay the price for these actions.

What is the right equity strategy for the RSA going forward given where we have come from and what potentially lies ahead?

The honest truth is no one knows exactly what the future holds. If so, this person would simply be a money machine and we have yet to meet one. Based on historical precedent and the fact market cycles tend to last roughly 16.9 years on average, we think cautious optimism is the right mindset for equity investors. Because of this intersection of the cyclical bull and secular bear where we find ourselves presently situated, we have a very unusual juxtaposition of market sentiment in which we have a healthy level of fear which provides the necessary wall of worry (markets normally don't collapse when everyone is worried about them) and an unhealthy level of complacency as seen by historically low levels of the VIX or Credit Suisse Fear Barometer Index.

Chart 5: 5-year VIX Chart



Source: Bloomberg

To make matters more complicated, we have a market that is "reasonably" priced based on earnings expectations for 2013. Given that expectations for earnings of the S&P 500 are just a little over $100 for the coming year, it is a pretty easy back-of-the-envelope calculation to see that the equity market is trading at 15x-16x forward earnings (6%-7% earnings yield for the market). Assuming a continued low GDP growth environment, it is reasonable to assume we are in a "normal" 8%-10% gain type equity market assuming market valuation multiples stay constant. Of course, everyone knows we have been in anything but normal markets over the recent years.

Our best assessment at the current time is the markets have more room to run in this cyclical bull much like the 1980 period coming out of the recovery from the 1973-74 market correction, but that caution is also warranted as we experienced one more recession/consolidation period before the markets finally made new highs in 1982 from which we never turned back. In 1980, the market was able to exceed the previous highs by roughly 15% before being corrected one last time. We think it is reasonable that we have a similar level of near term equity upside prior to a correction, but feel a correction of this four year cyclical bull is likely before we make new highs for good. As a matter of fact, a consolidation/correction is probably healthy at some point in the near future given the relatively steep rise of the last four years.

Under our base case scenario, we continue to maintain a healthy level of domestic equity exposure which is weighted more heavily toward the higher quality, large cap sector of the marketplace. We have begun to layer into some put spread collar protection on our SPX index holdings in an effort to protect the strong gains we have seen in the first quarter of this calendar year. This strategy best expresses the view that upside exists, but we want to make sure we hold onto the gains we have experienced to this point in the fiscal year.

Consistent with the late innings of a cyclical bull, we do expect continued M&A and private equity activity/transactions and see the technology sector as especially well positioned for consolidation given the large cash balances that are present on many of the larger, slower growing technology companies. The management buyout attempt of Dell is a good example of a recent transaction that is possible in this type of market environment. Oracle's buyout of the faster growing Acme Packet is another example of the type of strategic M&A we expect to continue in the sector. M&A has also occurred outside the technology sector as witnessed by Warren Buffett's Berkshire Hathaway taking Heinz private in a very large deal. We expect this type activity to continue throughout 2013.

In addition to M&A activity, we expect short squeezes to continue as many names simply still have too high short interest relative to the very low volume market which currently exists. Netflix is a good recent example of what a fundamental catalyst plus short interest can do to a stock.

The final characteristic of the current market that is interesting is the high level of activist activity. The likes of Carl Icahn, David Einhorn, and Bill Ackman are very busy taking large stakes in companies and trying to extract value. Of course this type activity would have borne substantially more fruit four years ago, but this activity tends to happen later in cyclical bulls once confidence returns to the marketplace.

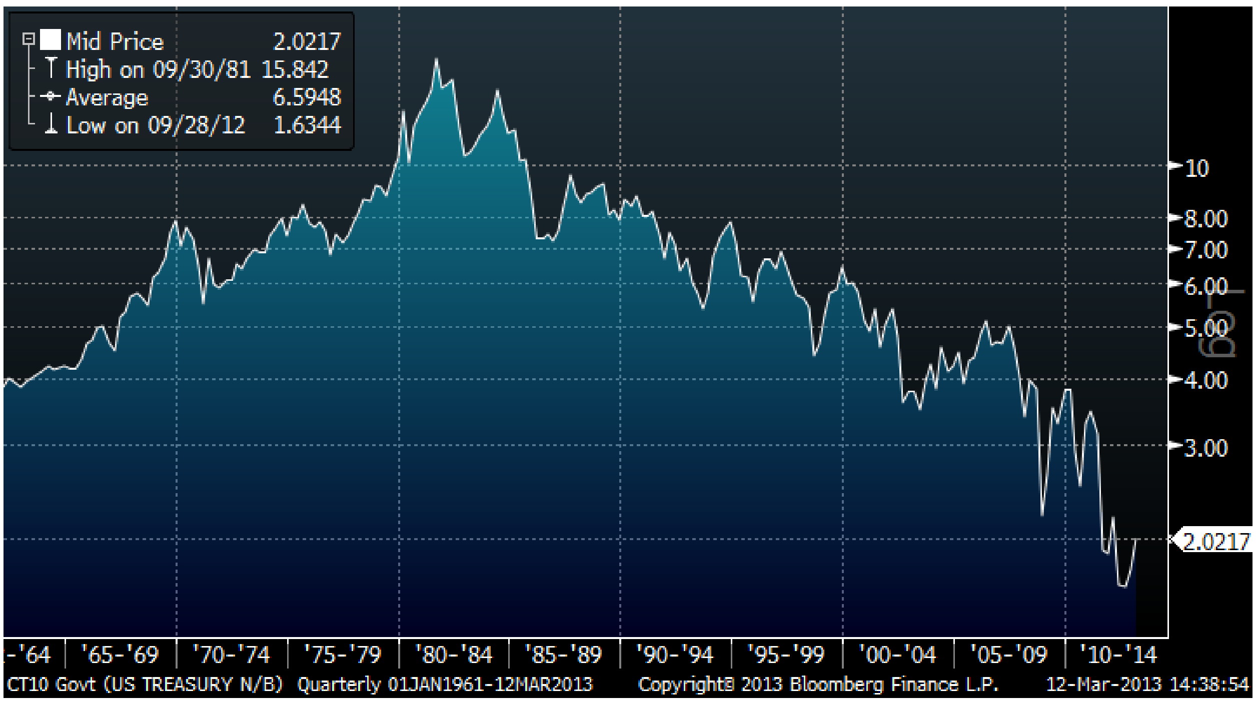
While M&A activity, short squeezes, and activist activity are shorter term boosts to the market, we do recognize these are activities which can indicate a maturing market. Increased activist activity is not inconsistent with our equity investment stance that more upside remains in the cyclical bull, but that we need to be on guard in looking for cracks in the cyclical bull which could reveal pending market weakness.

Why has Fed policy put defined benefit pension funds in a checkmate type situation?

For many years as a public pension fund, it was possible to purchase US government bonds and know that if held to maturity, the return on those bonds would be in the range of the 8% required rate of return for the pension fund on an annual basis. During much of the 1970s and early 1980s the return exceeded the 8%. With the 10-year treasury yield currently hovering around 2% and the 30-year treasury rate hovering around 3%, we are simply no longer close to that situation. To complicate matters, if bond yields are ever to return to favorable rates for defined benefit investors who buy and hold to maturity, then by definition capital losses will be sustained on the fixed income portfolio before getting to this level. This has implications for the equity side of the investment ledger as asset allocators must take a certain level of risk in the equity markets in an effort to compensate for the lack of return in the fixed income market. Sure, it is possible for fixed income to see capital appreciation from this level and for rates to go lower should we enter a deflationary environment. We not arguing these investments don't have their place in our portfolio, but it puts an extra level of burden on the equity side. If rates go lower from here, it simply makes the long term checkmate problem that much worse. This is perhaps the biggest issue facing defined benefit pension plans in the current area given the very low level of risk-free interest rates.

The following chart takes a look at the 10-year treasury note yield over time relative to an 8% actuarial rate of return.

Chart 6: 10-Year Treasury Note Yield versus 8% Actuarial Rate of Return

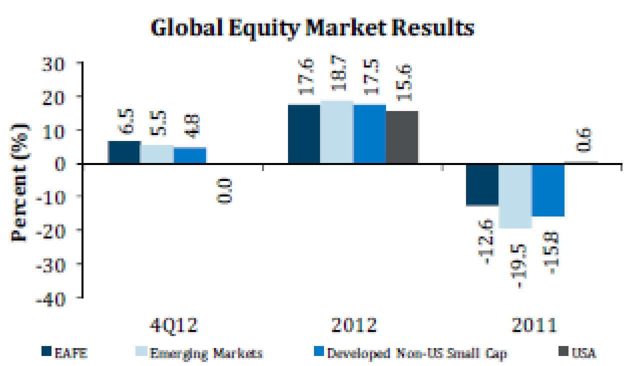


Source: Bloomberg

International Equity Strategy

By Steve Lambdin

Even in the face of several notable headwinds, global equities posted good returns in the fourth quarter of 2012. Global equity investors seemed to look through a potential U.S. fiscal cliff as policymakers in Washington continued with a “kick the can down the road approach” toward reformative policy actions. Investors continued to find comfort in the profound central bank stimulus actions designed to spur the various economies around the globe. As anxiety began to wane, investors put some risk on and this pushed most equity markets into positive territory in the fourth quarter. In a nutshell, even though we see many issues to worry about going forward for most of us, things seemed to be incrementally better for many investors. Concerns around a Greek exit from the Euro and subsequent meltdown of the Eurozone don’t seem to be on the forefront of most investors minds’ at this point, even though this certainly seems to be an issue somewhere down the road. China looks to have avoided a hard landing scenario in 2012, and by most indications, could see economic growth in 2013. The European economy could be stronger as we look deeper into 2013. Corporate profits seem to be holding up surprisingly well recently, as cost cutting programs look to be the main driver of this rather than stronger revenue growth. However, even as investors have pushed aside so many areas of concern lately, we still see a relatively weak global economy. Also, the U.S. fiscal cliff and debt ceiling issues remain an ongoing problem which still lacks an adequate long term solution. Many parts of the world remain stuck in social unrest, such as the civil war in Syria, Iran/Israeli tension, and recent posturing of the North Korean government. If any of these areas “ignite” and spread, then we could see some level of a shock to the global economy, with many different outcomes possible, most of which should be quite negative. At this point, the issues pointed out above are certainly not new to most investors as we enter 2013. We are watchful of developments with regard to these concerns, but still believe markets can still be strong as markets can climb the so called “wall of worry” longer than many believe until any of these issues become the next focal point for investors.

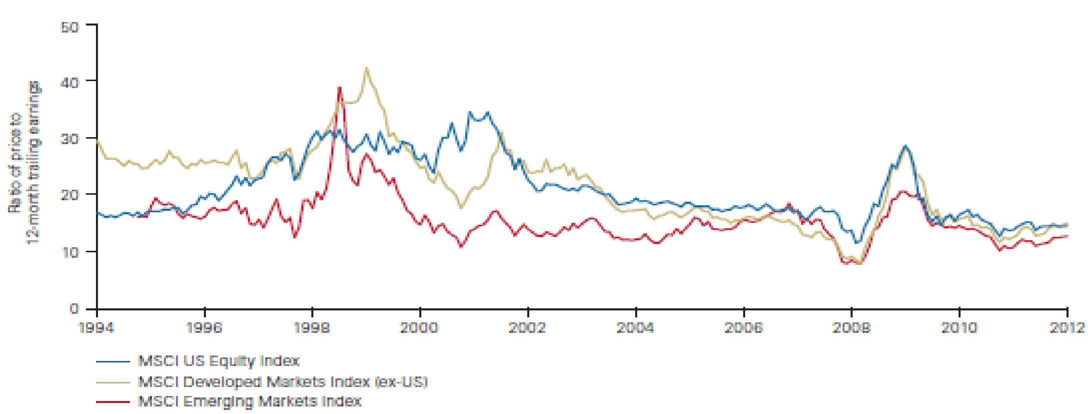


Source: William Blair

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +6.57% and +5.58% respectively during the fourth quarter of 2012 vs. -.38% for the S&P 500 Index. This was the second quarter in a row where international equities outperformed U.S. equities. For the calendar year 2012, the MSCI EAFE Index and the MSCI Emerging Markets Index also outperformed the S&P 500 Index by a very slight margin. Equity investors continued to find better "bargains" in international equities as valuations remained well below that of U.S. stocks. The U.S. Dollar Index was nearly flat in the fourth quarter and therefore was not a source of positive or negative performance during the period. The European region performed better than the Asian basin, as the Japanese equity market was just a slight detractor of performance from the rest of Asia. From an economic sector standpoint, Financials, Industrials, and Basic Materials led the way as Telecom, Energy, and Technology were weaker on a relative basis.

So far into the first quarter of 2013, equities have continued to trend upward as investors have become a bit more comfortable with the global outlook and have continued to push money flows into global equities. Whether this is the beginning of a more broad rotation into global equities from fixed income remains much too early to be seen. The MSCI EAFE Index, Emerging Markets Index, and the S&P 500 Index posted returns of +5.50%, +1.00%, and +9.50% respectively thru early/mid-March. The prospects for global growth to move back toward trend levels seem to have been a positive catalyst for equity investors thus far in 2013. This coupled with the continued unprecedented support of the global central banks provides a nice backdrop for equity market gains. Also, several macro related tail risks to the global economy have been diminished over the last couple of months, further providing a tailwind. As we look out in the first half of 2013, we would not be surprised to see many of the economic data points begin to get better and confirm what many investors are feeling. Perhaps this can lead to a favorable climate for further equity market gains in 2013.

Figure 10. Market valuations are similar across the major equity benchmarks



Sources: Thomson Reuters Datastream, Vanguard

Asia Update

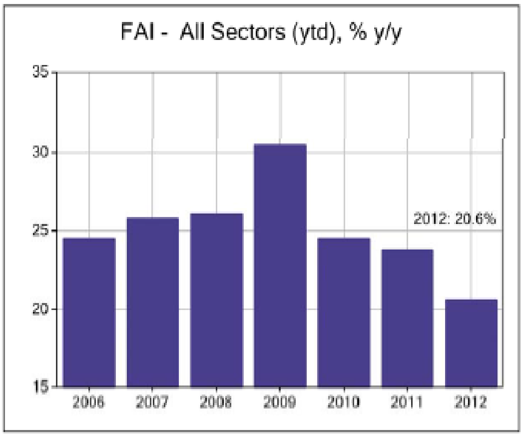
Equity market returns in the Asian region looked good as we saw gains in all markets. The MSCI Pacific Basin was up +6.1% in USD. After a weak third quarter, the Japanese equity market rebounded as the election of Prime Minister Shinzo Abe ushered in a vow to pursue aggressive monetary easing to end deflation. Japanese equities would have been stronger had it not been for the significant gain in the U.S. Dollar vs. the Yen in the quarter. Overall, business conditions still remain good relative to other regions around the globe. Chinese equities continued to rebound in the quarter as growth fears were overblown.

Market Performance

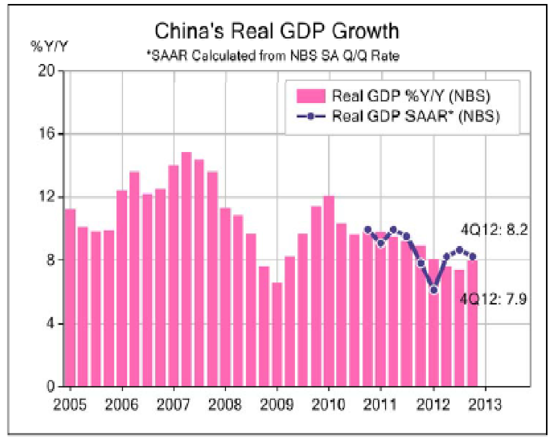
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI China	4.81	12.87	22.75
MSCI Philippines	2.82	11.50	46.44
MSCI Australia	2.92	6.84	22.07
MSCI Thailand	6.09	5.86	34.53
MSCI Japan	5.30	5.78	8.18
MSCI Hong Kong	0.89	5.66	28.27
MSCI Korea	5.14	4.80	21.18
MSCI Singapore	3.00	3.17	30.96
MSCI Taiwan	0.90	1.54	16.68

Source: Factset

The government's efforts to drive growth in the Chinese economy paid off in the fourth quarter of 2012. Gross Domestic Product (GDP) rose +7.9% from the year earlier period, which was the fastest rate of growth in two years. This is a big piece of the global recovery puzzle as China accounts for a large percentage of overall global growth. Industrial production rose +9.9% in the first two months of 2013, providing further evidence things are beginning to stabilize across the region. Chinese consumers still remain strong as retail sales continued to accelerate in late 2012 and were up +14.9% in November and +15.2% in December. Exports have resumed their growth as well and were reported up +23% in the first two months of 2013, which was quite a positive surprise. Fixed asset investment continues to be strong and was reported up +21.2% in early 2013, which is above the pace we saw in late 2012. However, in just a bit of concern, consumer prices rose +3.2% in January, the highest rate in well over a year. While we don't view this rate especially problematic, we feel we need to see this rate stay below the +3.6% level in order not to bring inflationary fears to the forefront of investor thinking. As we move through the early part of 2013, we like what have seen in the Chinese economy thus far. The economy continues to be strong domestically and we look for the export side of the economy to pick up substantially as well and provide the strength as we move through 2013. We would not be surprised to see government officials actually raise growth estimates at some point if growth continues at this pace. This should be a good climate for Chinese equities going forward as investors become confident in the outlook for this region. The main area of risks as we see it at this point remains the potential for rising inflation as growth accelerates and the weak outlook in Europe as well. Both of these could be tough to overcome if they worsen form current levels.

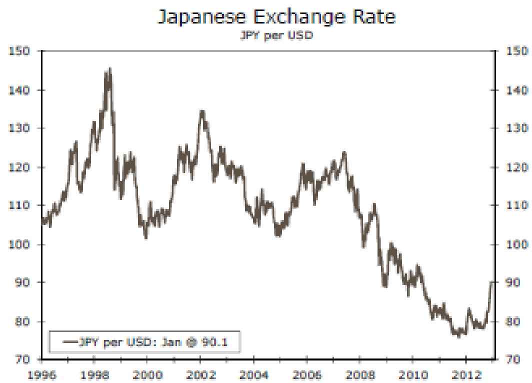


Source: ISI

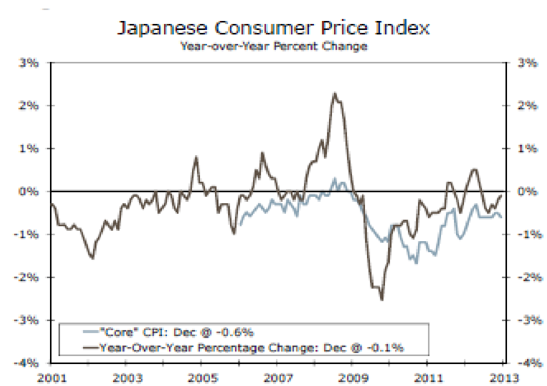


Source: ISI

After a weak third quarter of 2012, the Japanese economy may have passed the bottom in economic growth over the near term. Fourth quarter GDP rose +.1% from the previous quarter, or +.2% from the year earlier period, as measures put in by the new administration may be taking hold. Exports in January rose +6.4% from a year earlier, which is the first increase in exports in eight months. Exports to the U.S. and China have been exceptionally strong, while European exports remain weak from the ongoing recession across Euroland. Benefiting exports has been the Yen's -13% fall against the dollar over the last few months. Automobile manufacturers as well as the computer industry should be key benefactors of the Yen's slide. However, the currency's slide does hurt imports, as the country will pay more for key energy inputs going forward as a large part of Japan's nuclear energy output remains idle. This will put pressure on the trade deficit and will probably force government officials not to force even further weakening of the currency over the near term. Industrial production rose in December and January, the first two-month increase in quite some time. This is further evidence of the ongoing recovery in this region. Good news on the production front has spread to the consumer as well. Consumer confidence rose to 44.3 in February, the highest level in several years. However, deflation still remains firmly in control, as consumer prices fell for the eighth time in nine months. Consumers are still reluctant to accept price increases, which continue to pressure top line revenues at many companies. This will probably force the Bank of Japan (BOJ) to announce new stimulus measures over the next few months in an effort to fight deflation. Key labor reports seem to be getting slightly better on the margin. The unemployment rate remained steady at 4.2% in January, while the jobs to applicant ratio improved to .85 from .80 in October. Going forward, we believe the actions taken by the new government are providing a path to growth for this economy. We believe economic growth estimates going forward probably need to be raised, as we expect a good climate for exports. As usual, deflation remains a menacing problem, and we expect fresh government actions directed toward this to be a top priority.



Source: HIS Global Insight and Wells Fargo



Source: HIS Global Insight and Wells Fargo

Europe Update

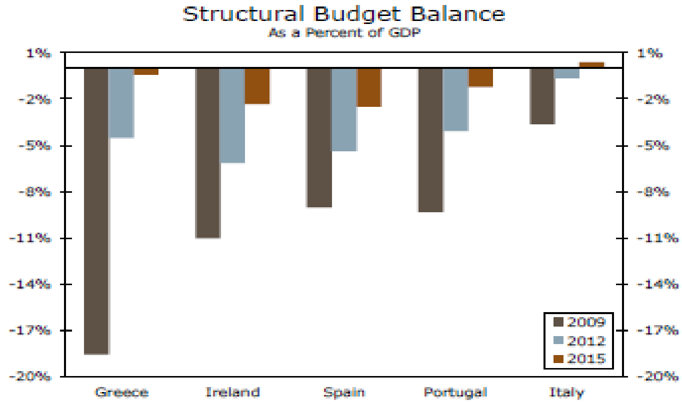
European equities rallied in the fourth quarter despite a barrage of negative economic reports on the regions' health. Investors seemed to be very encouraged by the European Central Bank's (ECB) bond buying program as well as Euroland finance officials reaching a deal on Greece's debt situation. As we have seen here in the U.S., when you have unprecedented support by your region's central bank, credit spreads tighten and this usually brings added comfort to investors and generally transpires to upward moving equity markets. This is certainly happening across Euroland. European equities again posted positive returns as the MSCI European Index rose +7.1% in the fourth quarter. The European region finished as the best performing region within the broader MSCI EAFE Index, as investors rushed into cheap equities across the region. Rhetoric around the ongoing recession in Euroland will be the focus for most investors over the next few months. Positive news on this front could translate into further gains in the equity markets, as we expect the markets to remain very reactionary to these developments.

Market Performance

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI France	3.58	10.83	21.29
MSCI Spain	4.56	9.59	3.00
MSCI Netherlands	2.75	9.44	20.59
MSCI Italy	3.60	9.28	12.48
MSCI Germany	4.02	8.51	30.90
MSCI Switzerland	1.29	8.04	20.35
MSCI United Kingd	2.07	4.17	15.25

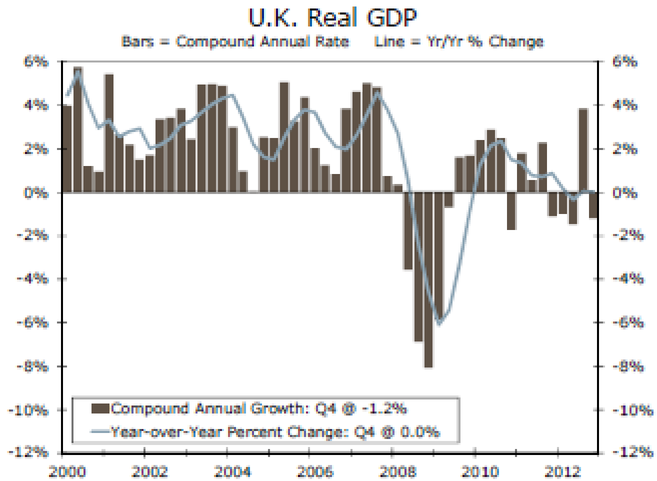
Source: Factset

The Euroland economy remained firmly in a recession in the fourth quarter of 2012, as GDP fell -.6% from the previous quarter or -.9% from the year ago period. This is the third quarter in a row of negative growth and is the worst performance in this region in nearly four years. Unfortunately, this is a reflection of low consumer sentiment toward spending as well as lackluster global demand for the region's products and services. Based upon what we see, we would expect this to continue into early/mid 2013, as relief is still some time away for this region. Germany and France, which have been pillars of strength in previous periods, actually experienced negative growth in the quarter. Companies continue to struggle with uneven demand for products, forcing most to continue their respective cost cutting programs in an effort to defend profit margins. Industrial production fell -.4% in January from December, or -1.3% on a year over year basis, as manufacturing remains very weak. However, one data point has been positive lately. The index of executive and consumer sentiment has risen from the lows of October and was reported at 91.1 in February. Perhaps this is an early sign the economy may be getting better in the region as we move into the spring. Retail sales did manage to gain +1.2% in January from December, even though they remain down on a year over year basis. We feel this statistic will remain very spotty and erratic over the next few months, with no clear trending pattern. Unemployment continues to set new records with each passing month. The Euroland unemployment rate was reported at 11.9% in January, the highest level in two decades. The latest estimate puts approximately 19.0 million people out of work in this region. Unfortunately, we still do not feel we are at the bottom of the employment cycle at this point. Inflation continues to trend downward and was reported at +1.8% in February, with core inflation falling to -1.3%. This rate remains well below targeted levels by the ECB. The ECB has maintained its key refi rate at .75% at its February meeting. However, with inflation well below acceptable levels, this could pave the way for a cut at some point as economic risks remain well to the downside according to the latest ECB report. At this juncture, perhaps we are very near a low point in this region's economy.



Source: International Monetary Fund and Wells Fargo Securities, LLC

With the absence of a one-time surge from the summer Olympics, the U.K. economy struggled in the fourth quarter of 2012. GDP in the fourth quarter fell -.3% from the previous quarter, even though we saw a +.3% gain on a year over year basis. Net trade detracted -.1% from GDP as exports fell and services also slipped in the quarter. Industrial production also continues to be tough, as production in January fell -1.2% from December. This is mainly from several oil platforms which were off-line in January as well as a slumping economy in Euroland, which is the U.K.'s main trading partner. Retail sales fell for the second month in a row in January as extremely harsh winter weather put a damper on spending plans. Income gains from consumers remain rather bleak, as wage increases are harder to come by. Inflation has remained very stable lately and was reported at +2.7% in January from a year ago. This is a bit higher than the Bank of England (BOE) would like to see, as energy prices remain sticky. The Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds at its recent March meeting. The MPC feels the economy is just not weak enough to justify any further stimulus actions at the present time. News on the employment seems to be slightly better recently. The unemployment rate remains steady at 7.8% in December, even though employment jumped by 154,000 in the quarter and jobless claims have fallen for three consecutive months. Wage growth continues to be problematic, as wages only grew +1.4% in the fourth quarter of 2012 from a year earlier. As we review the data points coming out of the U.K. recently, we still see a weak economy in the early part of 2013 with very little to get excited about and feel we are a bit away from seeing a slow but sustained growth environment.



Source: HIS Global Insight and Wells Fargo

Other Regions

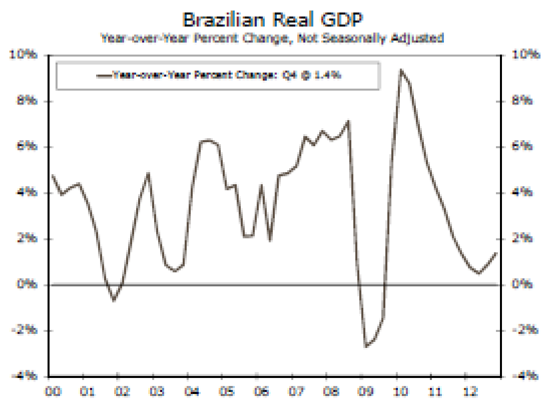
Even though developed market equities slightly outperformed emerging market equities in the fourth quarter of 2012, returns of +5.6% were nonetheless solid. All three regions, the EMEA, Asia, and Latin America posted positive returns in the quarter. As investors felt more comfortable with risk, this benefitted emerging market equities during this time. We would continue to expect emerging market equities to perform well as world GDP growth is expected to pick up as we move through the balance of 2013. As we have mentioned in the past, the characteristics of better growth profiles, stable debt levels, lower valuation levels, and attractive dividend yields are still applicable with regard to emerging market equities over the medium to longer term and make this asset class appealing for many investors.

Market Performance

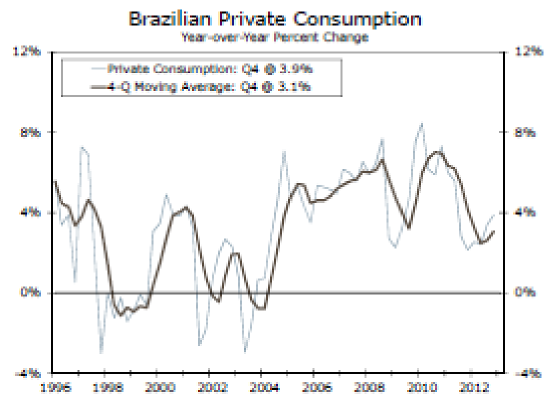
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI South Africa	9.99	6.16	18.69
MSCI Brazil	7.67	3.47	0.05
MSCI Russia	6.16	2.46	13.66
MSCI India	-0.02	0.48	25.97

Source: Factset

Brazil's economy continued its slow growth pattern established through most of 2012 in the fourth quarter. GDP growth of +.6% in the fourth quarter from the previous quarter, or +1.4% from a year earlier, was about what many had expected. Significant monetary stimulus continues to be felt here and expect this to boost domestic demand and consumption in 2013. Industrial production was strong in January, rising +2.5% from the previous month, or +5.7% from the year ago period. This was the best one month rise in several months and we believe this is an indication of what is to come as we move deeper into this year. Retail sales continue to climb, rising by +5% year over year in December. The consumer seems to have a willingness to spend, as this continues to support the region. However, recent inflation readings still seem to be stubbornly high. February's reading of +6.3% remains well above targeted levels. Past interest rate decreases and reductions in electricity tariffs seem to have raised inflation rates. The unemployment rate jumped in January to 5.4% from the record low of 4.6% in December. However, we still see this as fairly low and believe the employment situation in Brazil remains structurally sound. We still expect to see growth in 2013 well above what we saw in 2012, and feel this could be a nice catalyst for the equity markets.

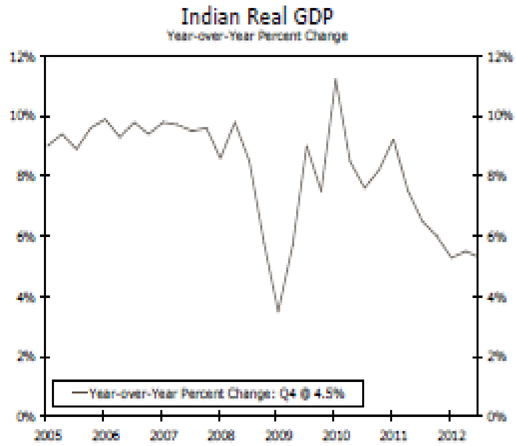


Source: HIS Global Insight and Wells Fargo

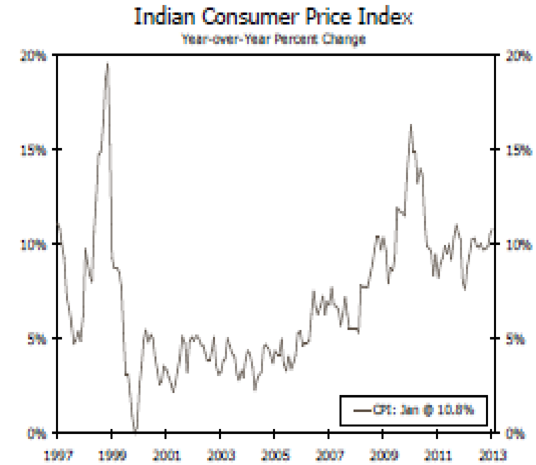


Source: HIS Global Insight and Wells Fargo

GDP growth in India was reported up +4.5% on a year over year basis in the fourth quarter of 2012. This rate of growth was the slowest pace of economic expansion in a few years, as the mining and agriculture industries were the weakest areas of the economy. Even though we saw some better results with industrial production in January, we still see growth being challenged over the near term. Perhaps some of the structural reforms being presented by the country's finance minister can come to fruition in 2013, as high interest rates and inflation seem to be crippling the outlook here.



Source: HIS Global Insight and Wells Fargo



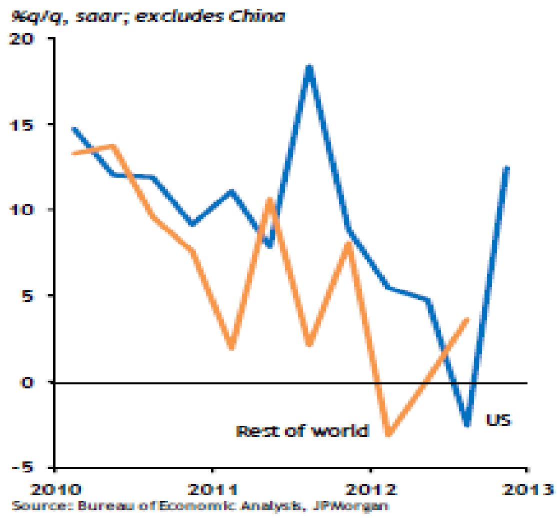
Source: HIS Global Insight and Wells Fargo

International Equity Activity/Strategy

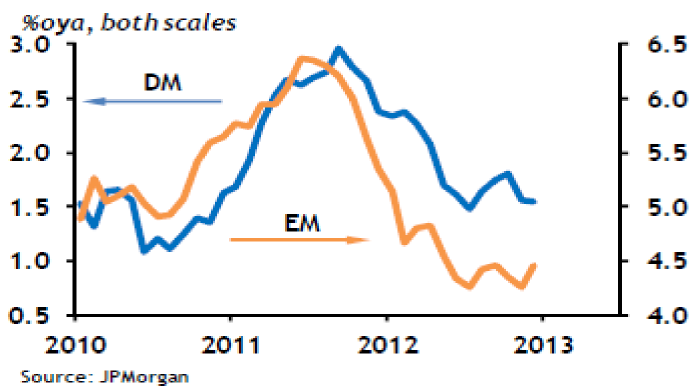
As always, the global equity investment landscape is full of potential question marks and uncertainties with a wide multitude of outcomes. This time is certainly no different. We feel the outlook in early 2013 is a bit different than several months ago. On the positive front, the U.S. has at least temporarily averted a huge fiscal cliff; the news flow around the European debacle has actually been a bit more positive; China looks to have avoided a hard landing in its economy; the new Japanese leadership appears to be taking an aggressive stance to fighting off deflation; inflation seems not be problematic at this point; and housing data look more positive in certain parts of the world. At the same time, we have our usual negative points such as: a murky employment picture in Europe; a slowing of corporate profits; U.S. debt ceiling issue; European economic growth, etc. As we add up the scorecard, it seems as though investors are discounting a better climate ahead for equity investors and early 2013 seems to reinforce this view. Gains thus far into 2013 have been decent. At this point, we are hoping for continued good news with regard to the issues mentioned above which could translate into further market gains. Nonetheless, even though not as attractive as a few months ago, global equities still look decent from a valuation standpoint.

We did sell approximately $31.3 million of our emerging markets equity ETF in mid-December as the price of this ETF moved slightly above our strike price on our written calls. We have continued to sell put options on this index in an effort to repurchase what we sold at a slightly lower price in addition to adding fresh money to this index at prices even further below this. The volatility in the equity markets may provide us with this opportunity. Premiums for doing this still look attractive in the current environment. Our current allocation to Emerging Market equities is approximately 1.5% of total assets and approximately 12.2% for MSCI EAFE equities. *(Charts provided by Bureau of Economic Analysis, JP Morgan, Markit, William Blair, Wells Fargo, HIS Global Insight, Factset, ISI, Thomson Reuters Datastream, Vanguard, and IMF)*

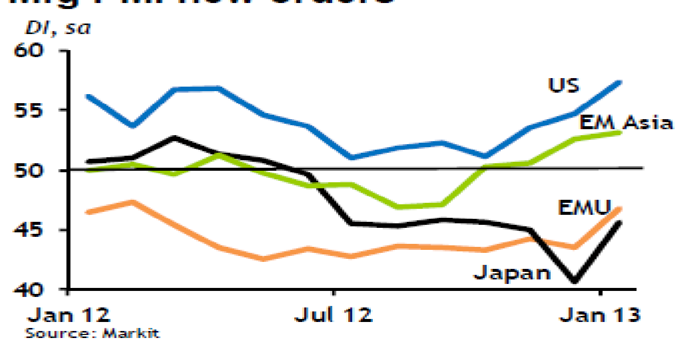
Global capex



Global inflation



Mfg PMI new orders



TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
TRS CORE FUND	1,798,800,000	5.13	7.22	5.13	5.51	12.91	12.06	2.87	7.73	Oct-94
TRS S&P 500 FUND	4,684,298,126	5.19	6.77	5.19	4.82	16.78	14.26	4.08	8.03	Oct-94
TRS MID CAP INDEX	1,008,748,051	7.22	11.98	7.22	11.07	19.07	17.64	8.11	11.70	Oct-94
TRS S&P SMALL CAP INDEX	591,729,306	5.82	10.56	5.82	8.43	16.42	18.17	8.09	11.62	Mar-01
TRS SMALLCAP ACTIVE FUND	142,876,870	5.30	9.13	5.30	5.59	10.42	13.23	5.51		Jun-06
TRS MIDCAP ACTIVE FUND (SSF)	676,768,098	7.26	12.31	7.26	9.93	19.24	19.01	8.18	11.26	Oct-94
TRS TOTAL DOMESTIC EQUITY	8,903,220,453	5.60	8.12	5.60	6.26	16.26	14.37	4.40	8.58	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		5.61	8.00	5.61	6.20	17.02	14.94	4.81	8.72	
S&P 500		5.18	6.75	5.18	4.78	16.78	14.14	3.97	7.93	
S&P 400 MIDCAP		7.22	11.98	7.22	11.09	18.56	17.57	7.99	11.64	
S&P 600 SMALL CAP		5.78	10.36	5.78	8.12	15.45	17.57	7.40	11.46	
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	294,659,536	-0.24	8.44	-0.24	8.03	7.98				Oct-11
TRS INTERNATIONAL EQUITIES	2,473,325,806	5.33	11.40	5.33	12.28	17.78	7.58	-0.25	9.71	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,767,985,342	4.71	11.09	4.71	11.81	16.69	7.42	0.02	9.94	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY IND		4.84	10.87	4.84	11.60					
MSCI EAFE (NET)		5.27	11.27	5.27	12.19	17.25	6.94	-0.79	9.24	
MSCI EMERGING MARKETS (NET)		1.38	7.69	1.38	7.03	7.64	7.17	2.04	16.73	

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TRS TOTAL GLOBAL EQUITY	11,671,205,794	5.39	8.82	5.39	7.54	16.42	12.65	3.30	8.84	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		5.42	8.67	5.42	7.44	16.95	12.90	3.36		
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,580,088,041	-0.51	-0.44	-0.51	0.04	4.16	6.57	6.56	6.94	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		-0.76	-0.84	-0.76	-0.31	3.62	6.14	6.10	5.56	
TRS TOTAL FIXED (ex. Private Placements)	2,580,088,041	-0.51	-0.44	-0.51	0.04	4.16	6.57	6.56		Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		-0.76	-0.84	-0.76	-0.31	3.62	6.14	6.10		
Barclays Aggregate Bond		-0.70	-0.68	-0.70	-0.49	2.59	5.41	5.45	5.10	
TRS PRIVATE PLACEMENTS	2,145,058,614	0.65	1.45	0.65	2.15	17.92	15.15	1.57	6.57	Aug-99
TRS CASH ACCOUNT	156,924,459	0.37	1.17	0.37	2.17	2.31	0.90	1.08		Sep-03
TRS TOTAL FIXED INCOME	4,882,071,115	0.03	0.43	0.03	1.00	9.80	9.93	3.85	6.57	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	357,128,480	0.47	-0.74	0.47	0.36	48.46	13.35	-24.67		Sep-03
TRS REAL ESTATE	1,973,476,898	0.03	0.04	0.03	0.04	4.91	1.46	0.78		Oct-03
TRS SHORT TERM INVESTMENTS	471,565,992	0.04	0.11	0.04	0.15	0.46	0.39	1.21		Oct-03
TRS OPTION COLLATERAL	0	0.00	0.00	0.00	0.00	0.00				Sep-03
TRS TOTAL ALTERNATIVES	2,802,171,370	0.09	-0.04	0.09	0.10	7.78	2.27	-4.84		Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,684,242,485	0.05	0.26	0.05	0.67	9.05	7.36	1.04	4.50	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
TRS TOTAL PLAN	19,355,448,279	3.19	5.22	3.19	4.68	13.37	10.33	2.27	6.71	Oct-88
TRS TOTAL PLAN POLICY		4.18	6.72	4.18	5.86	13.32	10.21	3.98		

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
ERS CORE FUND	968,628,826	5.13	7.21	5.13	5.50	12.95	12.10	2.89	7.74	Oct-94
ERS S&P 500 FUND	2,119,450,866	5.19	6.76	5.19	4.82	16.77	14.26	4.08	8.06	Oct-94
ERS MID CAP INDEX	446,208,531	7.22	11.98	7.22	11.07	19.11	17.66	8.12	11.72	Oct-94
ERS S&P SMALL CAP INDEX	243,355,319	5.82	10.56	5.82	8.43	16.42	18.17	8.09	11.64	Mar-01
ERS SMALLCAP ACTIVE FUND	70,582,084	5.28	9.11	5.28	5.55	10.43	13.24	5.51		Jun-06
ERS MIDCAP ACTIVE FUND (SSF)	364,978,279	7.25	12.34	7.25	9.97	19.23	19.02	8.22	11.34	Oct-94
ERS TOTAL DOMESTIC EQUITY	4,213,203,905	5.60	8.12	5.60	6.26	16.17	14.32	4.36	8.58	Oct-93
ERS CUSTOM DOMESTIC EQUITY INDEX		5.61	7.99	5.61	6.19	17.04	14.92	4.79	8.70	
S&P 500		5.18	6.75	5.18	4.78	16.78	14.14	3.97	7.93	
S&P 400 MIDCAP		7.22	11.98	7.22	11.09	18.56	17.57	7.99	11.64	
S&P 600 SMALL CAP		5.78	10.36	5.78	8.12	15.45	17.57	7.40	11.46	
INTERNATIONAL EQUITY										
ERS EMERGING MARKETS FUND	140,717,746	-0.24	8.44	-0.24	8.03	7.98				Oct-11
ERS INTERNATIONAL EQUITIES	1,088,077,309	5.33	11.40	5.33	12.28	17.77	7.61	-0.24	9.69	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	1,228,795,055	4.66	11.06	4.66	11.77	16.61	7.43	0.07	9.95	Nov-94
ERS CUSTOM INTERNATIONAL EQUITY IND		4.80	10.84	4.80	11.56					
MSCI EAFE (NET)		5.27	11.27	5.27	12.19	17.25	6.94	-0.79	9.24	
MSCI EMERGING MARKETS (NET)		1.38	7.69	1.38	7.03	7.64	7.17	2.04	16.73	

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
ERS TOTAL GLOBAL EQUITY	5,441,998,960	5.39	8.78	5.39	7.47	16.32	12.69	3.34	8.84	Oct-93
ERS CUSTOM GLOBAL EQUITY INDEX		5.43	8.63	5.43	7.37	16.97	12.98	3.42		
FIXED INCOME										
ERS DOMESTIC FIXED INCOME	1,174,660,169	-0.51	-0.44	-0.51	0.03	4.16	6.56	6.54	6.96	Sep-99
ERS CUSTOM DOMESTIC FIXED INDEX		-0.76	-0.84	-0.76	-0.31	3.64	6.16	6.09	5.55	
ERS TOTAL FIXED (ex. Private Placements)	1,174,660,169	-0.51	-0.44	-0.51	0.03	4.16	6.56	6.54		Oct-03
ERS CUSTOM GLOBAL FIXED INDEX		-0.76	-0.84	-0.76	-0.31	3.64	6.16	6.09		
Barclays Aggregate Bond		-0.70	-0.68	-0.70	-0.49	2.59	5.41	5.45	5.10	
ERS PRIVATE PLACEMENTS	1,063,159,348	0.65	1.43	0.65	2.15	17.63	15.31	1.45	6.40	Aug-99
ERS CASH ACCOUNT	92,589,146	0.26	0.71	0.26	1.33	1.47	0.62	0.92		Sep-03
ERS TOTAL FIXED INCOME	2,330,408,663	0.06	0.45	0.06	1.02	9.90	10.10	3.69	6.49	Oct-93
ALTERNATIVE INVESTMENTS										
ERS PREFERRED STOCK	252,999,393	0.32	-0.75	0.32	-0.02	39.00	16.39	-19.97		Sep-03
ERS REAL ESTATE	958,292,875	0.03	0.04	0.03	0.04	4.86	1.32	0.69		Oct-03
ERS SHORT TERM INVESTMENTS	382,749,741	0.03	0.11	0.03	0.15	0.45	0.39	1.20		Oct-03
ERS OPTION COLLATERAL	0	0.00	0.00	0.00	0.00	0.00				Sep-03
ERS TOTAL ALTERNATIVES	1,594,042,008	0.08	-0.07	0.08	0.05	8.01	2.90	-6.37		Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,924,450,671	0.06	0.24	0.06	0.63	9.14	7.53	0.15	4.06	Oct-93

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>TOTAL PLAN</u>										
ERS TOTAL PLAN	9,366,449,631	3.07	5.00	3.07	4.47	13.19	10.33	1.80	6.42	Oct-89
ERS TOTAL PLAN POLICY		4.15	6.63	4.15	5.76	13.20	10.13	3.94		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
JRF S&P 500 FUND	109,590,781	5.19	6.76	5.19	4.82	16.93	14.22	4.12	8.06	Oct-94
JRF S&P MID CAP INDEX	13,381,024	7.23	11.99	7.23	11.08	18.59	17.66	8.12	11.73	Oct-94
JRF S&P SMALL CAP INDEX	5,329,510	5.82	10.56	5.82	8.43	16.42	18.17	8.09	11.66	Mar-01
JRF TOTAL DOMESTIC EQUITY	128,301,315	5.42	7.44	5.42	5.59	17.09	14.78	4.65	8.51	Oct-93
JRF CUSTOM DOMESTIC EQUITY INDEX		5.41	7.42	5.41	5.54	16.92	14.56	4.42	8.34	
S&P 500		5.18	6.75	5.18	4.78	16.78	14.14	3.97	7.93	
S&P 400 MIDCAP		7.22	11.98	7.22	11.09	18.56	17.57	7.99	11.64	
S&P 600 SMALL CAP		5.78	10.36	5.78	8.12	15.45	17.57	7.40	11.46	
INTERNATIONAL EQUITY										
JRF EMERGING MARKETS FUND	4,366,743	-0.23	8.44	-0.23	8.03	7.98				Oct-11
JRF INTERNATIONAL EQUITIES	32,455,923	5.36	11.42	5.36	12.33	17.81	7.83	-0.07		Nov-06
JRF TOTAL INTERNATIONAL EQUITY	36,822,666	4.66	11.07	4.66	11.81	16.42	7.70	0.71		Nov-06
JRF CUSTOM INTERNATIONAL EQUITY IND		4.79	10.82	4.79	11.54					
MSCI EAFE (NET)		5.27	11.27	5.27	12.19	17.25	6.94	-0.79	9.24	
MSCI EMERGING MARKETS (NET)		1.38	7.69	1.38	7.03	7.64	7.17	2.04	16.73	
JRF TOTAL GLOBAL EQUITY	165,123,981	5.25	8.24	5.25	6.92	17.05	13.55	3.96	8.24	Oct-93
JRF CUSTOM GLOBAL EQUITY INDEX		5.27	8.17	5.27	6.84	16.87	13.09	3.47		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>DOMESTIC FIXED INCOME</u>										
JRF DOMESTIC FIXED INCOME	60,880,187	-0.45	-0.33	-0.45	0.11	4.34	6.64	6.49	6.89	Oct-93
JRF CUSTOM DOMESTIC FIXED INDEX		-0.75	-0.82	-0.75	-0.30	3.31	6.05	5.90	5.54	
Barclays Aggregate Bond		-0.70	-0.68	-0.70	-0.49	2.59	5.41	5.45	5.10	
JRF PRIVATE PLACEMENTS	3,097,244	0.23	1.78	0.23	2.67	4.16	2.90	-0.07	6.71	Oct-01
JRF CASH ACCOUNT	5,875,885	0.27	0.76	0.27	1.18	1.32	0.57	0.89		Sep-03
JRF TOTAL FIXED INCOME	69,853,316	-0.38	-0.18	-0.38	0.26	4.11	6.03	5.48	6.83	Oct-93
<u>ALTERNATIVE INVESTMENTS</u>										
JRF PREFERRED STOCK	0									Nov-07
JRF REAL ESTATE	3,180,141	0.00	0.00	0.00	0.00	8.00	13.07	8.80		Oct-03
JRF SHORT TERM INVESTMENTS	2,999,762	0.03	0.13	0.03	0.18	0.57	0.47	1.28		Oct-03
JRF TOTAL ALTERNATIVES	6,179,903	0.04	0.12	0.04	0.34	3.09	4.62	3.29		Oct-03
JRF TOTAL F.I. PLUS ALTERNATIVES	76,033,219	-0.33	-0.15	-0.33	0.27	3.98	5.95	5.29	6.56	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
JRF TOTAL PLAN	241,157,200	3.40	5.41	3.40	4.71	12.53	10.79	4.59	7.54	Oct-93
JRF TOTAL PLAN POLICY		3.53	5.49	3.53	4.73	12.57	10.52	4.07		