GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 1Q 2014

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

As I suggested would happen in my year-end comments, intermediate and long-term interest rates declined in the first quarter of 2014. The general consensus is that the lower rates were caused primarily by weaker-than-expected economic indicators, all of which pointed toward a slowing of GDP growth. Looking forward, however, most economists are forecasting that the rest of 2014 will see faster growth, with most estimates in the 3–3.5% range. The common view in the markets is that interest rates merely experienced a first quarter reprieve, perhaps weather-related, and that inevitably, they will head higher with a pickup in economic activity. Once again, those expecting interest rates to rise seem to miss some vital points.

The dual rise in mortgage rates and home values has put a damper on the general housing

Continued on inside

INDEX PERFORMANCE	CURRENT QUARTER	ONE YEAR
3/31/14		
Barclays 10-Year Municipal Bond Index	3.13%	0.54%
Barclays Aggregate Bond Index	1.84%	–0.10%
Barclays High Yield Index	2.98%	7.54%
Dow Jones Industrial Average	–0.15%	15.66%
S&P 500 Index	1.81%	21.86%
Russell 2000 Index	1.12%	24.90%
NASDAQ Composite	0.83%	30.18%

FIRST QUARTER 2014 MARKET OVERVIEW

ECONOMY

- Geopolitical events and challenging winter weather across the U.S. negatively impacted our economy this quarter. Economic conditions weakened early in 2014 evidenced by slowing growth in the housing sector, employment coming in below expectations and a dip in consumer confidence.
- Non-farm payrolls were below expectations but remained positive and the unemployment rate dropped to 6.7%. This decline was viewed negatively as it was driven by workers leaving the workforce instead of new job creation. The job market participation rate is at its lowest since 1978.
- March saw a rebound in several key economic data points including durable goods, consumer spending and consumer confidence.
- GDP for the fourth quarter was revised upward to 2.6% from 2.4%, but still trailed the 2.8% forecasted growth.

FED ACTION

- The January FOMC meeting was the last to be chaired by Ben Bernanke and the March meeting was the first for the new Fed Chair, Janet Yellen. The federal funds target rate remains unchanged at 0–0.25%. The Fed indicated it will look at a wide range of data in determining when to raise its benchmark interest rate, dropping a pledge tying the interest rate to 6.5% unemployment.
- As expected, the Fed announced the continued tapering of their monthly bond buying program at their first quarter meetings. If tapering continues at the current pace, these purchases will end later this year.
- In March, the Fed surprised the bond market by indicating rate hikes would occur sooner than expected. The market is now pricing in the first increase in the first quarter of 2015, three to six months earlier than previously anticipated.

BOND MARKETS

- Yields declined in most areas of the bond markets. A string of weaker economic numbers, coupled with softening economic news from China and the conflict in the Ukraine, caused longer-term Treasury yields to fall, as 10-year and 30-year rates declined 31bps and 41bps, respectively.
- Most sectors of the taxable bond market posted strong results. Both investment grade and high yield corporate bonds performed well, as investors flocked to these sectors despite the uneven economic news. Ultimately, spreads closed the quarter at their tightest levels since the onset of the Lehman crisis.
- Municipal bonds also had a successful quarter. Ten-year AAA municipal rates dropped 32bps during the period to 2.49%. The municipal market benefited from strong technicals as new issuance slowed considerably and fund flows returned to positive territory following $60 billion in outflows in 2013.

EQUITY MARKETS

- Most major equity indices finished the first quarter in positive territory with modest gains despite the development of some macroeconomic concerns. Mid-cap stocks emerged as the leader while small caps exhibited the weakest relative performance.
- Value stocks in all market segments outpaced growth stocks, a trend that can be partially attributed to the significant decline in high-flying momentum stocks and biotech late in the quarter.
- Generally, defensive sectors such as Utilities and Health Care outperformed while the more economically sensitive sectors such as Consumer Discretionary and Technology lagged.
- Merger and acquisition activity accelerated meaningfully this quarter. U.S. corporations have strong balance sheets, capital markets are wide open, and management teams use M&A to grow if organic options are unavailable.

ECONOMIC COMMENTARY, continued from page 1

market. Another 1% increase in mortgage rates could further hurt housing starts. Many argue that mortgage rates of the past were much higher than today's level of 4.5% and housing starts did just fine. That is true, but it was a different economic environment. In those years, there was far less unemployment and underemployment. Wages were rising and families often consisted of two working parents. At the time, a house was thought to be a valuable investment and even if a family had to stretch to afford the payments, they could always be paid off with future appreciation. This attitude is far less prevalent today. Too many now worry more about the illiquidity of a home and often prefer the flexibility of apartment living over appreciation potential.

Besides the consumer, the other major debtor in the U.S. is the Federal Government. With $13 trillion of public debt outstanding, any material increase in interest rates will have a significant impact on the annual deficit. It is true that the U.S. Treasury has made an effort to extend the average maturity of its outstanding securities, which had fallen to just 48 months in October of 2008. But by the end of last year, the Treasury had only managed to push that out to 67 months (or roughly 5.5 years). And there is little reason to believe it will go much higher considering the four decade peak, reached in May of 2001, was only 71 months. It is this reality that gives pause to the Federal Reserve Bank, which is walking a tight rope. To keep rates too low for too long risks creating inflation, but increasing rates too quickly could crush the slow recovery, spawn another recession, or even worse, ignite a deflationary spiral à la Japan.

Keeping all that in mind, we believe intermediate and long-term interest rates should remain in a fairly narrow band, moving up or down roughly 0.5% in response to the typical noise produced by the markets. When the Fed finally increases short rates in a year or two, the yield curve will flatten from its currently steep position. But like we saw in the final weeks of March, we expect that flattening to take the form of short rates rising in line with Fed action while intermediate and long rates either hold their ground or even decline.

What, if anything, does this mean for the stock market? Well, it seems that many want the stock market to decline. Sounds ridiculous, but my casual observation is that many would-be investors who were burned in 2008 and 2009 are underweighted in stocks either because they panicked in the crash or took money off the table during this five-year rally. There is another, supposedly more sophisticated group of investors, who have invested in all sorts of hedge funds and absolute return funds, searching for more "predictable" returns that elevate risk avoidance to a top priority. The problem with this approach is the return on these investments has not kept up with stocks. Those investors who are satisfied with lower returns in order to protect capital are not so dissimilar to those who, fearing a rise in interest rates, will invest in money market funds or short-term bond instruments to prevent losses. The similarity is the acceptance of safety over return.

Does that sound like a market top? The fact is, bull markets climb walls of worry and that is the world we find today. Capital preservation and fear of losses are overriding greed and euphoria. Early in my career, most portfolios would have had a 50–75% commitment to stocks. Today it is often less than half of that, even in institutional portfolios, because of diversification into many types of alternative investments. There may be appropriate and opportunistic reasons for a multiple discipline portfolio, but one result is a much lower commitment to equities as an asset class and domestic equities in particular.

Adding to the psychology of the day is the practical fact that Americans are aging and the WWII baby boomers are living longer, becoming more conservative and saving more. But savings that stagnate in the banking system will not trigger inflation. On this matter, the monetarists have been wrong. It is a sudden pickup in the velocity of money, not the supply of the money itself, which injects inflation into the system and destabilizes the investment climate. In this economic environment, the buildup of reserves has been benign due to the slack in the economy that prevents money from quickly changing hands. And yet, many still worry that inflation is just around the corner.

Fearing a return to 2008 and 2009, there is a tendency to hunker down and play it safe, providing the perfect setting for investors to thrive. And so the combination of conservative asset allocation, hoarding of capital and fear of losses will continue to create a wonderful backdrop to good old fashioned stock and bond investing. Enjoy the ride.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE

TOTAL ASSETS UNDER MANAGEMENT	$19.8 Billion
TOTAL EMPLOYEES	101
TOTAL INVESTMENT PROFESSIONALS	32

GROWING OUR EQUITY TEAM

At the end of last year we welcomed Jacqueline W. Williams, CFA, as a new addition to our equity investment team. She is responsible for discovering and analyzing companies primarily within the Health Care sector in the small and mid cap market segments. Jackie has developed a deep knowledge of the Health Care sector throughout her investment career, has focused on the small cap market for more than a decade, and shares our philosophy of seeking out quality companies. Visit www.gwkinvest.com for more information on Jackie.

MUNICIPAL BOND STRATEGIES

INVESTMENT TEAM

Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Martin R. Tourigny, CFA	Partner, Portfolio Manager
Brian T. Moreland, CFA	Principal, Portfolio Manager

12 Municipal Investment Professionals	**18** Average Years Experience	**13** Average Years with Firm

"With tax rates at generational highs, valuations against Treasuries historically cheap and credit conditions as favorable as they've been in years, the municipal bond market has an enviable cushion against the unknowable unfolding of events."

GW&K MUNICIPAL BOND STRATEGIES

SHORT-TERM MUNICIPAL BOND	Seeks to earn higher after-tax returns than money market funds while managing risk
FIVE-YEAR MUNICIPAL BOND	High-quality active approach aims to preserve and enhance capital and targets an average maturity of five years
MUNICIPAL BOND	High-quality intermediate approach with goal to preserve and enhance capital emphasizes research and active management
MUNICIPAL ENHANCED YIELD	Long-term approach that includes an allocation to higher yielding bonds with a goal to produce high after-tax income

Municipals posted strong returns in the first quarter, driven primarily by a surprising rally in the Treasury market. While the Fed's tapering of its quantitative easing program proceeded as expected, the result was not the inevitable rise in interest rates many predicted. Rather, weak economic data and international unrest resurrected a long dormant flight-to-safety trade and the bond market rallied hard to begin the year. Inflation continued to be non-existent, allowing long bonds to hold their gains even when, in mid-March, the Fed suggested interest rate hikes could come earlier than many anticipated. The resulting recalibration of expectations led to a sharp rise in shorter interest rates, and for the quarter as a whole, the yield curve flattened dramatically.

The municipal market was further affected by technical factors. Municipal bonds experienced a classic "January Effect," rallying out of the gates due to a combination of scarce new issue supply, high seasonal rollover demand and a sudden drying up of mutual fund outflows, which had surged in December due to year-end tax-loss harvesting. The supply vacuum stayed in place the entire quarter.

Meanwhile, for most of the quarter, heavy retail demand for shorter bonds caused the front end of the tax-exempt curve to rally in line with the longer end. This was followed by a sharp sell-off in the front end triggered by a more hawkish sounding Fed. Over the next few weeks, five-year tax-exempt rates retraced their bullish run of the previous two months and finished only three basis points lower for the quarter, right in line with the move of their Treasury counterparts.

Credit fundamentals continued to exhibit strength. States extended their streak of revenue growth to 16 consecutive quarters and budget management remained focused on containing costs and rebuilding reserves. Even Puerto Rico was able to establish some positive momentum, issuing a general obligation deal for the first time in two years, though they paid dearly (8.73% tax-exempt yield) for market access. With the island recently downgraded to junk status and the buyers dominated by non-traditional investors, any fallout headline risk was well contained. And with municipal bond default rates still at their historically minute levels, the demand for municipals seems as robust as ever.

As we move further away from the depths of the Great Recession, the resiliency of the municipal market becomes more and more impressive. The spending discipline that helped balance budgets in the darkest times led to a dip in new issue supply which in turn helped keep the market firmly bid through shaky periods of demand and transitional turns in monetary policy. While the broader markets obsess over the implications of the Fed's forward guidance, municipal investors can take comfort in the value of tax-exempt paper. With tax rates at generational highs, valuations against Treasuries historically cheap and credit conditions as favorable as they've been in years, the municipal bond market has an enviable cushion against the unknowable unfolding of events. While we cannot predict with certainty what those events will be, we can be sure that opportunities will accompany them. We will be ready.

After the two-month rally to begin the year, the bear flattening in March brought some much needed rationalization to the front end of the curve. In retrospect, retail investors had been too aggressive in piling into five-year bonds, driving absolute yields below 1%, a drop that far outpaced the move in five-year Treasuries. We recognized that the divergence versus Treasuries was fueled as much by retail's fear of rising rates as it was the positive technicals that pushed yields down across the rest of the curve. And so we responded by selling five-year paper into that bid and investing the proceeds out longer. As a result, we lightened up on the richest part of the curve while picking up nearly 200 basis points in additional yield.

Looking ahead, our focus remains on maximizing carry and roll. While our duration is slightly lower than the index, we still have a healthy exposure to longer bonds to maintain flexibility and protect against any decline in rates or further flattening of the yield curve. Our credit focus continues to center on essential purpose revenue authorities as we avoid the general fund debt of local governments.

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Lead Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Schuyler S. Reece, CFA	Vice President, Portfolio Manager

10 Taxable Investment Professionals	**15** Average Years Experience	**9** Average Years with Firm

GW&K TAXABLE BOND STRATEGIES

SHORT-TERM TAXABLE BOND	Through research and diversification, seeks to outperform money market funds while managing portfolio volatility
CORE BOND	A core multi-sector bond strategy that offers a more conservative profile by selecting only investment grade securities
ENHANCED CORE BOND	Offers broad market exposure across multiple bond sectors, including high yield bonds, while seeking to provide strong income
TOTAL RETURN BOND	This multi-sector approach takes advantage of relative valuation among distinct bond sectors and seeks to generate high income and capital gain
CORPORATE BOND OPPORTUNITIES	Seeks to maximize current income and longer-term capital appreciation by focusing on both high grade and high yield corporate bonds

This was supposed to be a year of stronger U.S. economic growth, accompanied by higher interest rates. Stocks were poised to rally on optimism about a world economic recovery, and interest rates were sitting near cycle highs as the Fed began tapering its asset purchases. But the narrative quickly changed. Driven by uncertainty in the emerging economies, markets began to experience renewed volatility. Specifically, a pronounced slowing of growth in China and geopolitical risks in the Ukraine threatened to derail global markets. Compounding this volatility was an exceptionally disruptive winter, which many blamed for a string of lower-than-expected economic data which raised doubts about the veracity of the U.S. economic expansion. Investors grew increasingly concerned over whether this was just a correction or the early phases of the next downturn. Adding to the collective list of worries was a slightly more hawkish Fed hinting that the first rate hike could come as soon as the spring of 2015. The FOMC continued to taper the size of its monthly asset purchase program, while moving away from its numeric thresholds in favor of qualitative forward rate guidance.

Rates began to rally across the entire yield curve right out of the gate. Then the mid-March FOMC meeting triggered a yield curve flattening as the market dramatically re-priced the timeframe for rate hikes. With the exception of the long bond, every tenor along the curve saw yields move higher. For the quarter, three-year rates were 10 basis points higher, and five-year rates were essentially unchanged. Meanwhile, 10-year and 30-year rates were lower by -31 basis points and -41 basis points, respectively. Ultimately, the Treasury sector returned 1.3%, contributing to a 1.8% return for the Barclays Aggregate Index.

After a rocky start to 2014, risk appetite returned in February as investors chose to attribute the weak economic data to the severe weather and treat the areas of geopolitical risk as localized. Corporate bonds performed well despite the hawkish commentary from the Fed, as spreads closed the quarter at their tightest levels since the onset of the Lehman crisis. Both investment grade and high yield corporates achieved returns near 3% for the quarter. Within the government-related sector, taxable municipals posted a strong return of 5.2%, helped in part by the sector's long duration. Mortgage-backed securities returned 1.6%, only marginally outperforming Treasuries.

We believe the weather is primarily responsible for the recent wave of weak and inconclusive data and expect the economy to reaccelerate in the months ahead. We also believe that the asset tapering program has been largely priced in and the threshold for the Fed to decrease its pace, or even pause, is very high. In light of this, the focus now will be on the effectiveness of the Fed's forward guidance and trends in inflation, which should drive rate-hike expectations. Despite the rally in Treasuries to begin the year, the March FOMC statement and post-meeting press conference marked an inflection point in the market's concerns about interest rate risk. The certainties of a zero rate world are coming to an end, and the debate has shifted to when, how far and how fast the tightening cycle will proceed, and how markets and the real economy will respond.

Given the uncertainty around the Fed's exit strategy and our expectations for a sharp rebound in economic activity as the effects of winter weather fade away, we remain underweight duration. We strongly favor investment grade corporate bonds over Treasuries. Corporations are still reporting solid earnings growth, margins are set to expand on any uptick in demand, and spreads still represent fair value. The favorable outlook for investment grade is also anchored by fund inflows. We remain overweight the high yield sector in applicable strategies as fundamentals are generally robust and as the reality of income and coupon starvation keeps demand high. We remain neutrally positioned in the mortgage-backed sector. While yields in the space are still attractive relative to Treasuries, technicals should turn negative sometime in the latter half of the year, as the absence of Fed support is likely to lead to wider spreads.

"The certainties of a zero rate world are coming to an end, and the debate has shifted to when, how far and how fast the tightening cycle will proceed, and how markets and the real economy will respond."

EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Joseph C. Craigen, CFA	Vice President, Portfolio Manager

10 Equity Investment Professionals	**16** Average Years Experience	**8** Average Years with Firm

GW&K EQUITY STRATEGIES

EQUITY DIVIDEND PLUS	Income oriented strategy that invests in companies paying above-average dividends and with the required balance sheet strength needed to sustain dividend payouts
DIVERSIFIED EQUITY	Combines growth & value disciplines and diversifies across large, mid, and small capitalization stocks
SMALL/MID CAP CORE	A core strategy that invests in both small and medium sized companies that offer sustainable earnings growth
SMALL CAP CORE	Focuses on small companies with sustainable earnings growth in niche markets with lasting growth potential
SMALL CAP GROWTH	Utilizes fundamental research and quantitative screening to identify small companies with sustainable, above-average earnings growth in niche markets

While it was a rather directionless quarter for stocks, with several brief periods of modest gains and losses, the broad market averages eked out small gains. For the second quarter in a row, larger cap stocks performed marginally better than smaller caps. The themes dominating the quarter included the crisis in Ukraine, a slowdown in China, the economic impact of poor winter weather, and the mixed interpretation of new Fed Chair Janet Yellen's public comments. None of these themes were so overwhelming as to cause any major market trend in either direction, although Yellen's reassuring dovish comments on the last day of the quarter sparked a rally that ensured all major indices would indeed end in the green for the quarter.

Large cap stocks as measured by the S&P 500 Index rose 1.8% for the quarter. All major sectors showed gains with the exception of Consumer Discretionary, where retail and consumer durables sales and profits were hit particularly hard by the poor winter weather. Utilities and Health Care, generally viewed as more defensive sectors, posted the strongest returns in the quarter of over 5%. Small cap stocks gained a scant 1.1% as measured by the Russell 2000 Index. As with larger cap stocks, all sectors but Consumer Discretionary advanced. Utilities and Energy were particularly strong, gaining over 5%. Across the market cap spectrum value oriented stocks outperformed growth stocks this quarter.

Our general stock market view continues to be positive, as prospects for continued economic growth are solid and signs of strength quite broad. The unemployment rate has dropped to 6.7%, a level not seen since 2008. Housing prices continue their upward trend, creating an important source of growth in household wealth. Survey work in areas such as consumer confidence, manufacturing and services all point to continued economic expansion as well. And while the Fed has begun its tapering plan, the FOMC has made it clear they will keep rates low as long as necessary to assure a sustained economic recovery. Continued low rates of inflation, currently below 2%, suggest the Fed can sustain its accommodative policies as needed without near-tem risk of inflation.

We believe the tailwind behind the demand for equities is intact. Cash flows into stocks remain positive. While this has been the case for the better part of a year, investors are still well underexposed to equities relative to historical levels. Individual investors remain flush with cash, and that cash should continue to find its way into stocks. Corporations also still have large cash balances and are generating strong cash flows, yet these cash balances are still earning anemic short-term rates of return. We expect companies will continue to use their cash for dividends, share buybacks and acquisitions, thus supporting equity returns. Indeed, all three uses of cash have been quite strong in the first quarter, and acquisition activity has accelerated meaningfully. Corporate profitability remains solid, and the level of profits should show continued growth in 2014. While the poor winter weather clearly hurt profits in some sectors of the economy, expectations are still for solid mid-high single-digit growth for the full year.

Since our premise for the market's continued advance is based on the continuation of earnings growth, we must remain diligent with respect to any signs of an economic slowdown. So far the concerns remain mostly offshore. China has experienced some slowing of demand. Russia has been hurt by the impact of its falling currency and Western sanctions following the Ukraine crisis. Emerging markets are being hurt by their dependence on commodity industries in a period of generally low commodity prices. And while growth trends in the U.S. remain generally intact, there are a few signs of slowing rates of growth in areas such as employment, housing and retail sales. We will watch to make sure the improving weather outlook indeed translates into the expected improvement in business trends.

While our outlook remains constructive, our investment focus has not changed. We continue to seek out well managed companies with sustainable and consistent growth prospects that should perform well across a full economic cycle. Such companies tend to protect on the downside yet still participate in the upside, providing above-average returns across the economic cycle. We continue to find new ideas that meet our criteria despite a strong stock market that has powered to record highs.

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