GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 2Q 2013

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

Did you hear the news? Interest rates are going up. Or is the news that they have already risen, or that they will go higher? And which rates—short, intermediate or long term? And oh, by the way, Bernanke is lost and doesn't get it—or does he? The stock market will fall in this environment. Or it will rise.

Holy cow—this chatter is so bloody boring and irrelevant. There is more talk about interest rates than foreign policy, the immigration bill and tax reform put together.

Why does society seem to be able to focus on only one event at a time? I so resent the press and their need to micromanage, as if any one of these talking heads could hold a candle to Bernanke! All they do is speculate and agitate. As much as I hate to dwell on the "story of the day," it is a topic raising concerns for many of you. So let's look behind the curtain of interest rates.

First and foremost, Fed funds rates (i.e., short-term rates) are not going up for a long while.

Secondly, intermediate and longer-term rates cannot sustain a meaningful increase because that would kill the fragile economy. Consumers, who still drive our economy (surprise, surprise), are finally feeling better. Their retirement funds are increasing and their home values have begun to rise, giving a boost to their perceived wealth. Lower rates have allowed them to refinance existing mortgages, freeing up income to either spend or save. With rents so high, there are clear advantages to buying over renting but

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INDEX PERFORMANCE *6/30/13*

	CURRENT QUARTER	YTD
Barclays 10-Year Municipal Bond Index	–3.11%	–2.77%
Barclays Aggregate Bond Index	–2.32%	–2.44%
Barclays High Yield Index	–1.44%	1.42%
Dow Jones Industrial Average	2.92%	15.20%
S&P 500 Index	2.91%	13.82%
Russell 2000 Index	3.08%	15.86%
NASDAQ Composite	4.52%	13.43%

SECOND QUARTER 2013 MARKET OVERVIEW

ECONOMY

- The employment picture continued to improve and the unemployment rate moved slightly lower to 7.6%. Weekly unemployment claims once again ended the quarter near post crisis lows.
- The housing market gained momentum as pending home sales and existing house prices increased.
- Consumer sentiment continued to brighten, driven by the improving employment outlook, rising home values and the strengthening stock market.
- Manufacturing continued to recover as the ISM national manufacturing survey has reported an expansion in activity in five of the first six months of this year.

FED ACTION

- The FOMC left the target range for federal funds at 0–0.25% and committed to keeping short-term rates at exceptionally low levels at least as long as unemployment remains above 6.5% and inflation below 2.5%.
- The Committee announced the continued purchase of $40 billion agency mortgage-backed securities (MBS) and $45 billion Treasuries per month.
- Chairman Bernanke indicated that if upcoming economic data are consistent with expectations, a tapering of QE purchases will likely begin later this year and continue in measured steps through the first half of next year.
- Chairman Bernanke emphasized that Fed policy is not predetermined. If conditions improve faster than expected, asset purchases could be reduced more rapidly. If the outlook becomes less favorable the tapering of purchases could be delayed.

BOND MARKETS

- The fixed income markets experienced significant volatility as the Fed signaled it may taper QE purchases sooner than the market anticipated.
- High yield corporate bond spreads widened significantly and high yield mutual funds experienced record outflows. This selling pressure pushed the average spread for the Barclays High Yield Index 60 basis points wider during May and June. Investment grade corporate bonds also succumbed to the selling pressure in June as spreads widened 20 basis points for the month and 13 basis points for the quarter.
- Municipals suffered their worst quarter of performance since the fourth quarter of 2010. During one three-day period in June, 10-year municipal yields shot up 52 basis points, the worst such stretch in 25 years. However, over the final three days of the quarter, 10-year rates rallied 25 basis points and a sense of normalcy was reestablished.

EQUITY MARKETS

- Stocks ended the quarter in positive territory but experienced increased volatility and a June correction in response to the Fed's tapering comments and fears of higher interest rates. June was the first losing month of 2013.
- Small cap stocks performed slightly better than larger caps this period, and when combined with the prior quarter's solid performance, small caps extended their lead for the year to date.
- Sectors and industries with high dividend yields such as Utilities and REIT's, and commodity-oriented sectors such as Energy and Materials posted losses this quarter.
- Consumer stocks performed well reflecting the upward trend in consumer spending and increased confidence levels.

JAPAN 10-YEAR GOVT BOND YIELD

Source: Ministry of Finance Japan, Bloomberg

consumers need to feel confident in the future and, for most, that means job security. In the end, economies are driven by attitude; optimism begets optimism and pessimism begets pessimism.

Our economy is still quite vulnerable. If attitudes shift back to fear, then capital will be hoarded rather than invested and the system will return to recession. But that recession would have little in the way of safety nets because the Federal Reserve is already doing everything it can possibly do and the government seems totally incapable of implementing policy shifts. One of the reasons Bernanke is talking about scaling back bond purchases from $85 billion per month is to provide some dry powder, just in case he needs to re-rescue the system.

So what does this all mean? The Fed needs to be very, very, very slow in allowing rates to rise. If by chance rates rise too fast and it kills the recovery, it will be very hard to regain momentum. This recovery is totally dependent on the Fed's ability to encourage further risk taking, to drive the cost of capital close to zero and to keep mortgage rates low.

Healing takes time. Interest rates will have to stay relatively low for a long while. I often compare the U.S. economy to Japan's and I show how—with a 10-year lag—we have followed Japan's interest rate decline perfectly for both 10-year and 2-year government paper. Of course, we are different from Japan in many ways, but one similarity is our aging, debt-ridden economy. To avoid Japan's mistakes and avoid deflation we need to allow our economy time to heal, with interest rates assisting rather than impeding that healing. Rates may rise through cyclical dynamics, but they can easily decline again. Since 1990, 2- and 10-year interest rates in Japan briefly spiked 100 basis points (1%) or more three separate times on their way to present levels, which are both less than 1% (see chart).

Finally, the overarching view is that Bernanke won't be able to unwind the Fed's balance sheet without causing financial havoc. And while I don't believe he (or his replacement) will unwind for many years, this lack of confidence in Bernanke (i.e., the Federal Reserve) no doubt stems from our society's general lack of confidence in government institutions. After all, why would we have confidence in the Fed when the government institutions we used to rely on failed so miserably in the past? Fair question. But if one reflects back on 2008 and 2009, the triumvirate of Bernanke, Paulson and Geitner managed the financial collapse with unbelievable astuteness. The rescue package for the troubled assets refinancing program (TARP) has been very successful. Of the $419 billion that was lent to struggling companies, most has been paid back, as the government's net cost is now down to $23 billion. The net cost for the rescue of mortgage companies Fannie Mae and Freddie Mac has been reduced to $60 billion from the peak of $187 billion. At the time many believed the government would be out trillions of dollars; at this point the government is out a total of $83 billion.

Does anyone talk about the success of the recovery programs? Have we forgotten that high yield bonds once traded at yields 20% higher than government bonds as opposed to the 5% spread today? Or that the stock market has doubled from its low? Or that capital markets are working freely? Does anyone care that we are slowly but steadily recovering from the worst recession in our lifetime? This was not luck on the part of those who orchestrated the recovery. The luck was that at critical times in history, we often have the right people in the right place. This was the case in 2008, and it is true today.

Have faith in Bernanke. I know it is not "In" to have faith, but I do. He will maintain a steady hand as he continues to lead us through this economic recovery. He is a student of the Great Depression and knows better than all of us about the psychology of the human mind as it relates to money, consumption and savings.

We as a society cannot take a chance of breaking the rhythm of the recovery. The Fed knows that—steady as she goes will be their cry. Stay fully invested, continue to enjoy the wonderful bull market in equities and take advantage of these higher interest rates.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE *6/30/13*

TOTAL ASSETS UNDER MANAGEMENT	$18.3 Billion
TOTAL EMPLOYEES	99
TOTAL INVESTMENT PROFESSIONALS	32

AWARD WINNING STRATEGIES

For the second consecutive year GW&K has won industry accolades for our top-performing actively managed investment strategies. *Investment Advisor* magazine selected GW&K as the Separate Account Manager of the Year in two of four categories. Our **Small/Mid Cap Core** and **Enhanced Core Bond** Strategies were recognized for their stability, repeatable investment process and in-depth research analysis. *Read more at www.gwkinvest.com.*

NEW STRATEGY NAMES

GW&K Small Cap Equity now GW&K Small Cap Core
GW&K Small/Mid Cap Equity now GW&K Small/Mid Cap Core

As our equity product line has grown to include style specific growth and value offerings, we wanted to clearly identify these two strategies as following a core approach, meaning that our portfolios may hold stocks that exhibit growth and/or value characteristics. This is a change in name only—the investment philosophy and process for each of these strategies remain the same.

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

22 Fixed Income Investment Professionals	**16** Average Years Experience	**10** Average Years with Firm

"As we look ahead to the third quarter, we are encouraged by a market that is much cheaper than it was a few weeks ago. Yields are higher. The curve is steeper. Valuations against Treasuries are more attractive."

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 5 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

Municipal bonds suffered their worst quarter of performance since the final three months of 2010, done in by a falling Treasury market, a surge in mutual fund outflows and a pullback in liquidity. After bottoming in early May, broader interest rates moved sharply higher over the final weeks of the quarter. The selloff started orderly enough as a response to better than expected economic growth but accelerated when the Fed began signaling an end to its open-ended quantitative easing program. Municipal bonds weathered the initial downdraft well due to supportive technical conditions. But broader volatility sparked a rush to dump mutual funds, igniting a negative feedback loop that took the market on a wild ride. During one three-day period toward the end of June, 10-year municipal yields shot up 52 basis points, the worst such stretch in 25 years. Investors who had been watching from the sidelines waiting for the selling pressure to end leapt at the opportunity to lock in tax-free yields not seen in two years. Over the final three days of the quarter, 10-year rates rallied back 25 basis points and a sense of normalcy was reestablished.

As we look ahead to the third quarter, we are encouraged by a market that is much cheaper than it was a few weeks ago. Yields are higher. The curve is steeper. Valuations against Treasuries are more attractive. And yet, fundamentals have remained solid. Credit quality was not a driver of the selloff. If anything, the credit backdrop is improving. The reason the market got spooked in the first place is because the Fed upgraded their outlook on the economy. At the state and local level, tax revenues have accelerated amid employment gains and an emerging housing recovery. The severe fiscal stresses of a few years ago were successfully overcome with conservative budgeting and extraordinary aid from the federal government. The few visible credit stresses cited in the press are idiosyncratic in nature and not likely to spill into the broader market.

All of which brings us back to valuation. Across the entire curve, AAA municipal yields are trading at or higher than comparable Treasury yields even though the highest marginal tax bracket has spiked from 36% to 43.4% when you add in the 3.8% Medicare surtax on investment income. During the height of the backup we were able to buy high quality paper inside 15 years at yields as high as 4% or more, which surpasses 7% on a taxable-equivalent basis! These are opportunities to embrace, not fear, which was evident when so many investors flocked back to the market to stem the tide. Even so, 10-year municipal yields begin the third quarter 80 basis points higher than year end. July and August have historically been very strong months for municipal bonds due to low supply and seasonally heavy rollover demand. Those technicals could be challenged a bit this year. Mutual fund outflow momentum may linger and new issue volume could be a little higher than usual if underwriters bring deals that had been postponed in June. This argues for a methodical approach in navigating what promises to be choppy waters ahead. But volatility perfectly complements active management and interest rate corrections create future value.

We reacted to the sharp rise in rates by extending our duration. Over the course of the month, we targeted for purchase bonds maturing in the 10-year area of the curve, stepping up our activity during the height of the selloff. We funded the purchases with cash and by selling 5-year bonds that had been held for just such an opportunity. The result was to lock in higher yields for a longer period of time. If rates move higher from here, we will extend again, selling more of our holdings invested in bonds shorter than the index. If they stay the same, we will harvest the better carry and roll we have established in this longer position. If they move appreciably lower, we may shorten duration and lock in the resultant capital appreciation. Regardless of how events unfold from here, we have the flexibility to adjust portfolio positioning accordingly.

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

22 Fixed Income Investment Professionals	**16** Average Years Experience	**10** 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

The second quarter of 2013 saw a marked increase in volatility in fixed income markets, as record low yields in May gave way to concerns that the Fed's stimulus program may come to an end sooner than the market had expected. Ten-year Treasury yields closed the quarter nearly 90 basis points above their recent lows, while credit spreads actually widened due to negative technical pressures. Outflows from the asset class overwhelmed the demand that usually surfaces in periods of rising rate and improving economic fundamentals. Weak performance across the entire fixed income space in June ultimately caused year-to-date returns to turn negative for higher quality, interest rate-sensitive assets, while speculative grade bonds were more resilient and remained in positive territory.

Long-term Treasury yields declined through April, a response to weaker than expected March data and the Bank of Japan's announcement of an aggressive stimulus program. By early May, 10- and 30-year bonds bottomed at 1.63% and 2.82%, respectively. However, as economic momentum picked up and the market came to grips with the likelihood of lower asset purchases from the Fed, rates moved sharply higher. By quarter end, the yields on 10- and 30-year bonds closed the quarter at 2.49% and 3.50%. The Barclays Treasury Index lost –1.93%.

Credit spreads tightened early in the quarter, as declining absolute yields supported demand for spread products. However, once the Fed announced the potential for reduced asset purchases, reach-for-yield and carry trades of all types fell out of favor and significant redemptions from all fixed income sectors followed. The investment grade corporate sector lost –3.31%, its worst quarterly performance since the credit crisis. The high yield sector made headlines in early May after absolute yields dipped below 5% for the first time in history. Those yields would climb 170 basis points through the end of June. In the end, the high yield sector fell –1.44% for the quarter.

Spreads on taxable municipals widened 22 basis points to 194 basis points over Treasuries. Coupled with a longer than average duration, this caused the Local Authorities sector to decline –5.23% for the quarter. Agency mortgage-backed securities submitted a stronger quarter in comparison, declining only –1.96%.

The message from the Fed seems to be that asset purchases are likely to be reduced at some point prior to the end of 2013, with an ultimate conclusion in the middle of next year. Separately, short rates are unlikely to be raised until sometime in 2015. In our view, this still implies a highly accommodative Fed and continues to make a case for being overweight spread product. Key data points to monitor will be the progress toward the Fed's stated thresholds for labor market improvement, any signs that higher rates might be curtailing the housing recovery, or evidence of a further slowdown in China.

At the beginning of the year we cut our duration exposure back toward neutral relative to our benchmarks, where we remain today. Despite the recent increase in yields, we continue to see little value in Treasuries and other government debt, as meaningful real rates of return in these sectors are found only in the very long end of the yield curve.

Valuations in the corporate sector are attractive, especially in light of the recent selloff, and fundamentals remain strong. Within high yield we continue to emphasize the double-B and single-B quality segments of the market given the still-benign default outlook. Early in May we tactically reduced our credit exposure by selling high yield bonds as yields approached all-time lows. In June, we began redeploying the proceeds from those sales back into the high yield market at more attractive levels. On the investment grade side, we remain biased toward triple-B issuers for the added income and expect the sector's spreads to compress as the recovery progresses. At the sector level, we remain biased to financial and industrial sectors exposed to an improving domestic consumer. We remain broadly neutral in the securitized sector but continue to favor premium coupon Agency mortgage-backed securities for their attractive yields, low duration, and modest extension risk.

"Valuations in the corporate sector are attractive, especially in light of the recent selloff, and fundamentals remain strong."

EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Edward B. White, CFA, CIC	First Senior Vice President, Portfolio Manager
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Joseph C. Craigen, CFA	Vice President, Portfolio Manager

10 Equity Investment Professionals	23 Average Years Experience	13 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

The market advance continued in stride for the first half of the quarter, registering mid single-digit percentage gains. Yet as interest rates began to climb in response to the Fed's comments suggesting that "tapering" could occur sooner rather than later, equity markets began to slide. While slow at first, the correction became more pronounced toward quarter's end as market fears about rising rates took down values on stocks and bonds alike. The Fed's attempt to clarify their position eased some of the market's fears, and stocks rallied back to positive territory in the final few days of the quarter. Tapering comments aside, economic news remains rather upbeat with continued positive trends in consumption, jobs, manufacturing and housing. Inflation remains tame, Europe is out of the headlines, and the fiscal crisis rarely makes the news.

Large cap stocks, as measured by the S&P 500 Index, ended the quarter up 2.9%. Following the first quarter's double-digit gain, the index is up 13.8% year to date. Small cap stocks finished the quarter with a slight performance advantage over large caps, and extended their lead over larger stocks with a return of 15.9% through the first half of the year. While most sectors were in positive territory for the quarter, sectors and industries with high dividend yields such as Utilities and REITs, and commodity-oriented sectors such as Energy and Materials posted losses.

Tapering, or the reduction in the Fed's bond buying program, has become the market's concern du jour. While tapering rattled the markets due to the potential rise in rates that investors anticipate and the reduced demand for bonds, the Fed has made it clear that tapering will only take place if they feel the economy has reached a period of self-sustained growth. So if rates rise in response to tapering, the economic backdrop should be interpreted as positive. Also, while rates may indeed rise somewhat, there are very few signs of inflation to suggest substantially higher interest rates are in order. Commodity prices ranging from food to metals to oil have all been weak, supporting our thesis of low inflation being maintained despite modest-to-moderate economic growth.

Indeed, most economic signs are quite constructive. Housing prices continue to rise, adding to consumers' wealth. We do not anticipate the modest rise in mortgage rates to alter this trend, as rates are substantially below historical levels. Consumer confidence remains strong. Retail sales, especially bigger ticket durables, also show good growth. Manufacturing similarly remains in positive territory, with capacity utilization still improving, and survey data still in expansionary mode. While GDP growth remains positive, the rate of growth is rather modest. Recent government adjustments put the rate at just under 2%. While a higher rate would feel better for us all, the current rate is supportive of continued growth without inflation. The global economy is still struggling to return to solid ground after the financial crisis that began six years ago; however, we do not believe the global growth concerns are enough to derail continued growth in our economy.

Given our generally positive outlook, we are nonetheless watching the impact of more modest economic growth on corporate profits. Corporations continue to have very large cash balances which will protect them in difficult times, and give them the capital to invest in growth, make acquisitions, or return to shareholders in the form of dividends or share repurchases.

With an increase in the stock market, valuation levels have risen modestly yet we believe they are in a reasonable range. Even with an increase in interest rates, stocks remain cheaper than bonds based on the historical relationship between interest rates and P/E ratios. And there is still a lot of pent up demand for stocks that will likely push the market higher over time.

We believe we are on the right track for recovery, although it is clearly happening slower than expected in some parts of the world. We remain attentive to the macro forces that impact the economy and the stocks in which we invest. By staying focused on well managed, quality companies selling at reasonable valuation levels and maintaining a long-term view, we believe we are in a strong position to protect our clients' capital and provide above-average returns over time.

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GW&K Investment Management
222 Berkeley Street
Boston, Massachusetts 02116
Telephone: 617 236 8900
Fax: 617 236 1815
www.gwkinvest.com

GW&K
INVESTMENT MANAGEMENT