GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 3Q 2013

www.gwkinvest.com

ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

As I sit in Jerusalem at this writing, I am struck by the Israeli way of governing relative to our recent experiences in the United States. In the U.S., we have lived with George W. Bush's and Barack Obama's line in the sand versus the Israeli position of "act without warning." Israel is a country that does not bow easily to public opinion—the need to survive outweighs the need to debate. When Israel attacked Iraq's nuclear site in 1981 and then Syria's nuclear site in 2007, they gave no warning and there was no public debate. Maybe survival needs that kind of decisive approach. History reveres leaders who galvanized public opinion—Teddy Roosevelt, Franklin Roosevelt, Harry Truman—and condemns those who cowed to consensus.

I don't want to turn this letter into a political commentary, so I will make my point. In the last few weeks both President Obama and Federal Reserve

Continued on inside

INDEX PERFORMANCE

9/30/13

	CURRENT QUARTER	YTD
Barclays 10-Year Municipal Bond Index	0.72%	–2.07%
Barclays Aggregate Bond Index	0.57%	–1.89%
Barclays High Yield Index	2.28%	3.73%
Dow Jones Industrial Average	2.12%	17.64%
S&P 500 Index	5.24%	19.79%
Russell 2000 Index	10.21%	27.69%
NASDAQ Composite	11.19%	26.12%

THIRD QUARTER 2013 MARKET OVERVIEW

ECONOMY

- Though the unemployment rate declined to 7.3% and weekly unemployment claims improved, the overall employment picture was mixed. Monthly non-farm payroll increases were lower than anticipated and a decline in labor force participation suggested a modest increase in discouraged workers.
- Home values and housing market indicators have improved significantly over the last year, however the strong momentum during the first half of 2013 slowed as higher mortgage rates impacted housing activity.
- Consumer sentiment softened as higher mortgage rates, increased tensions in the Middle East and the budget battle in Washington resulted in growing concerns about the economic outlook.
- Manufacturing activity continues to improve as the ISM national manufacturing survey reported an expansion during each month of the quarter. The survey's reading of 56.2% for September was the highest of the 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 that though economic activity had improved, it wanted to see more evidence of sustained progress before reducing the monthly purchase of $40 billion agency mortgage-backed securities (MBS) and $45 billion Treasuries.
- Chairman Bernanke indicated that the key headwinds to sustained economic progress include an uneven improvement in labor market conditions, a tightening of financial conditions and federal fiscal policy restraint.
- Most of the Committee expects the first increase in the fed funds rate to occur in 2015 with a median projection of 2% by the end of 2016. Given the expectation for ongoing economic headwinds, Bernanke stressed the importance of a patient approach to increasing the federal funds rate over the next several years.

BOND MARKETS

- Fixed income market volatility continued this quarter as the market anticipated a reduction of quantitative easing. However, bond yields moved significantly lower in September as the Fed decided not to taper its purchase program. For the quarter, 5-year Treasury yields moved 1 basis point lower, while 10- and 30-year yields moved 12 and 19 basis points higher, respectively.
- High yield corporate bond spreads tightened significantly as demand returned to this sector. However, the average spread for the Barclays High Yield Index is still 60 basis points wider than levels reached in early May. Investment grade corporate spreads tightened during the quarter as the average spread for the Barclays Investment Grade Corporate Index narrowed 11 basis points.
- Municipal bond yields marched steadily higher during July and August before moving significantly lower in September. Even with the recent rally, municipals remain cheap relative to Treasuries, particularly at the long end of the curve.

EQUITY MARKETS

- The stock market continued its advance unabated in July until fear crept back into the market and stocks corrected in August. As investors returned from their summer vacations the market once again resumed its upward climb, demonstrating resilience in the face of unresolved economic and political issues.
- While stocks of all sizes posted healthy gains in the third quarter, investors showed a sustained appetite for riskier investments as the return for small cap stocks was nearly double that of large cap stocks.
- Overall, the more economically sensitive sectors such as Materials, Industrials and Consumer Discretionary posted the strongest gains, while the more defensive and higher dividend-yielding sectors such as Telecommunication Services, Consumer Staples and Financials lagged.
- Fund flows into equities remained positive and may act as a continued tailwind for equity performance.

ECONOMIC COMMENTARY, continued from page 1

Chairman Ben Bernanke have caused great confusion by not properly telegraphing their shifts in policy. Obama was a moment away from punishing Syria's Assad regime for using chemical weapons, and Bernanke had prepared the world for some type of monetary tapering. Neither happened. Both decisions could have been entirely appropriate—negotiation is always preferable to military action and few appreciated just how fragile this economic recovery has been. But both men missed an opportunity to lead and both have invited needless speculation on where we go from here.

We have learned to steer clear of attaching too much weight to near-term events. In fact, last quarter I argued that our economy could not sustain a meaningful rise in long-term interest rates. The recovery had been built largely on a revival in the housing industry and the wealth effect that would create. When mortgage rates jumped 1%, re-financings all but disappeared and new mortgage applications dropped significantly. Unemployment is still uncomfortably high at 7.3% and the labor market is still dealing with the structural problems we've discussed in prior commentaries. The fact is, this economy has no room for error and Bernanke was probably right to postpone tapering. In trying to be open and transparent, however, he only whipsawed the bond market and drew investor attention away from focusing on the fundamentals of the economy.

So are policies of transparency appropriate in an untidy world with no square corners? Maybe leaders should talk softly and carry a big stick, and maybe we as investors should not base decisions on short-term expectations.

We at GW&K were struck by some of our newer bond client relationships who wanted to run from the bond market, clearly not understanding how rising interest rates help active bond managers to perform better in the long run by capturing higher yields. In fact, scores of investors fled the bond market in favor of cash. They decided that earning nothing on their money for an undetermined period of time was better than earning 3% to 4% over a determined period of time. Apparently, zero times X is better than 3% to 4% times seven. Why? Because zero is a predictable flat line, while the 3% to 4% over seven years is an unpredictable cyclical line. Many investors consider this uncertainty too risky, as if they were traders under constant pressure to read the tea leaves. This demand for transparency is as unnecessary as it is problematic. Investments fluctuate over time. Don't overreact to every swing in sentiment.

So now, since the Fed's latest decision to hold off on tapering, interest rates have fallen and the stock market has been fluttering. The headlines change but the fear continues. So what should an investor do? NOTHING. The whole reason a portfolio is diversified in the first place is because the world has shifting sands. Why else diversify? If we were Andrew Carnegie's "wise" man, putting all our eggs in one basket and watching the basket, then diversification would not be necessary. As professional money managers, however, we are committed to maintaining discipline, managing risk, and pursuing appropriate returns in all environments. Only an entrepreneur with his or her own money should make the big bets and concentrate capital the way Carnegie envisioned. That is not our job. Our focus is on risk-adjusted returns—we measure return versus risk. Having done this for 47 years, 39 years of that at GW&K, I believe we have seen enough to understand the sometimes complex tradeoffs between risk and return, and how to balance those forces while taking our clients' perspectives into full consideration.

The United States fortunately confronts no life or death decisions (i.e. survival), such as those faced by Israel, so policies can be more publicly deliberated. On the other hand, there might be a lesson to be learned from Israel: don't confuse transparency with predictability. Transparency may seem to light the road, but roads bend. I hope leaders begin to act with greater subtlety instead of tripping over their transparent words. We as a society and as investors need to respect the complicated world we live in and allow leaders to be less direct without losing confidence in them.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE	*9/30/13*
TOTAL ASSETS UNDER MANAGEMENT	$18.8 Billion
TOTAL EMPLOYEES	100
TOTAL INVESTMENT PROFESSIONALS	33

NEW EQUITY PROFESSIONAL

Leigh Shapiro Williamson recently joined GW&K as Vice President and Equity Specialist. As a member of our Equity Team, Leigh works closely with portfolio managers and analysts to support the firm's client service and business development efforts. This addition reflects the growing interest in our equity capabilities and our commitment to maintaining a high level of accessibility to our investment teams and process.

GW&K SMALL CAP CORE STRATEGY

The GW&K Small Cap Core Strategy has reached capacity and is officially closed to new investors. This strategy has delivered strong performance through its high quality, low turnover investment approach that focuses on a company's competitive position, financial health and management team strength. The talents of our small cap investment team can be accessed through our other small and small/mid cap strategies.

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	**17** Average Years Experience	**11** Average Years with Firm

"Even with September's decline in rates, the municipal bond market remains cheap. Yields on high quality, 10-year paper have risen nearly 80 basis points since the beginning of the year and stand 107 basis points higher than November's cyclical lows. Yields on 15-year paper are up 112 basis points for the year and 150 basis points since November."

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 posted positive returns in the third quarter thanks to a strong September rally that stopped a four month selloff in its tracks and reversed more than half of the year-to-date losses accumulated through August. Municipal bonds had been battling a growing negative sentiment since May, when broader interest rates first began rising after the Fed floated the idea of tapering their quantitative easing program. Large and sustained mutual fund outflows followed and negative headlines from Detroit and Puerto Rico did not help matters. By the first week of September, 10-year municipal bond yields had climbed as high as 3.04%, nearly 140 basis points above their early May lows, a historic selloff that stood with the post-Lehman backup as the worst correction in the last 25 years.

But as so often happens in the municipal bond market, particularly during a thin trading environment that receives little price leadership from the primary market, selling became overdone and valuations grew stretched to the downside. High quality, 20-year municipal bonds were suddenly available at 5% yields, or 8%+ on a taxable-equivalent basis. Ratios versus Treasuries reached as high as 106% in the 10-year area and 120% in the long end. Investors responded by stepping back into the market, slowly reversing the tide of rising rates. When the Fed announced that no tapering of its quantitative easing program was forthcoming, the positive momentum quickly turned into a full-on rally. From September 5 through the end of the month, the yield on 10-year municipal bonds plunged 50 basis points to end the quarter at 2.54%, a round trip journey that left it two basis points lower than where it began the quarter.

In a quarter that saw Detroit file for bankruptcy, Chicago suffer a three-notch downgrade and Puerto Rico have their market access questioned in a Barron's cover story, the fundamentals of municipal credits actually improved. State tax revenues continued to grow, the latest figures surpassing pre-recession highs even on an inflation-adjusted basis. Rainy day funds are being steadily replenished. The Boston College Center for Retirement Research published a report asserting that pension funded ratios most likely bottomed in 2012. California, the largest issuer in the municipal market, had its GO rating upgraded by Fitch. Texas, another large issuer of municipal debt, was upgraded to AAA at S&P. In fact, Moody's improved their outlook for the entire U.S. states sector to stable from negative. All of which explains why credit spreads away from the high-profile pockets of distress remained fairly stable across the vast majority of the market.

Even with September's decline in rates, the municipal bond market remains cheap. Yields on high quality, 10-year paper have risen nearly 80 basis points since the beginning of the year and stand 107 basis points higher than November's cyclical lows. Yields on 15- year paper are up 112 basis points for the year and 150 basis points since November. The curve is still historically steep, producing attractive carry and roll potential in a stable interest rate environment. The Fed is actively signaling to the markets its commitment to low rates, not only at the short end, by emphasizing extremely dovish forward guidance, but also at the intermediate and long end, by postponing the taper and suggesting they will buffer any potential tightening in fiscal policy. Even if we see volatility pick up in the near term, it is difficult to see yields spiking meaningfully from here—the Fed simply doesn't have the tolerance right now for higher interest rates. And the market also seems more vulnerable to downside surprises in the economic data. All of which points to the necessity of guarding against lower rates while acknowledging the longer-run pull of a slow-healing economy that could eventually put upward pressure on rates. For us, that means neutral duration positioning, a bias toward higher quality credits and an emphasis on the carry and roll still offered by a relatively steep yield curve.

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	**17** Average Years Experience	**11** 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

Toward the end of the second quarter, Fed Chairman Bernanke seemed to signal that the FOMC was preparing to taper its $85 billion monthly bond buying program sometime in the "next few meetings." With many investors expecting a reduction in purchases as early as September, the market endured a nearly unprecedented rise in interest rates during the summer. But, in an unexpected turn, the Fed decided to keep the level of asset purchases unchanged at the September FOMC meeting, catching most market participants by surprise. Fundamental factors appeared to drive this decision, as the Fed stated that they needed more time to assess the impact of tighter financial conditions, the sustainability of economic improvements, and the outcome of the looming fiscal showdown in Washington. This summer's disappointing labor markets reports were a likely indicator to the Fed that the broader economy is still too fragile to withstand higher interest rates. In addition to holding steady on its quantitative easing policy, the FOMC further cemented the accommodative stance of its forward guidance by suggesting that there will be no rush to hike rates even after normal economic conditions return.

Much of the quarter was characterized by a sharp rise in longer-term interest rates as the market braced for a September taper. Benchmark 10-year Treasury yields climbed nearly 50 basis points to 2.99% in early September. The decision to maintain stimulus came shortly thereafter, and, with investors fully embracing the Fed's forward rate guidance, 10-year rates rallied sharply to finish the quarter at 2.61%. The September rally erased total return losses for the quarter to date, as the Barclays Aggregate Index managed to squeeze out a slightly positive return of 0.6%. The yield curve steepened sharply as 30-year yields increased by 19 basis points. This left the difference between 5- and 30-year yields near its highest levels of the year at 230 basis points. Despite the increase in longer-term yields, Treasuries and Government-Related securities were able to break even and returned 0.1% and 0.3%, respectively.

Corporate bonds entered July near their widest spread levels of the year following the sharp selloff in June. Once investors became convinced that a gradual winding down of the Fed's quantitative easing program did not equate to an outright increase in the fed funds rate, spreads compressed throughout July and remained relatively range-bound for the rest of the quarter. High yield bonds were the best performing sector of the taxable bond market returning 2.3% while investment grade corporate bonds returned 0.8%. Mortgage-backed securities were the best performing segment of the Aggregate Bond Index and returned 1.0%.

"We came into the third quarter with a slightly shorter duration profile than our benchmarks while maintaining overweight positions in high quality spread product. This strategy offers some protection against potentially rising interest rates without giving up income."

We came into the third quarter with a slightly shorter duration profile than our benchmarks while maintaining overweight positions in high quality spread product. This strategy offers some protection against potentially rising interest rates without giving up income. If the pace of economic activity continues to strengthen and meet Fed expectations, bond investors in the short to intermediate part of the yield curve should eventually be rewarded with the opportunity to reinvest at higher yields. We expect current monetary policy to keep short to intermediate rates well anchored over the medium term. As such, our shorter duration is expressed in an underweight to the very long end of the yield curve, offset in large part by an overweight to exposures between three and seven years. We remain overweight the corporate bond sector as we are constructive on spreads heading into year end, and maintain a neutral allocation to the MBS sector.

We remain mired in a slow growth environment which seems likely to persist for the next few years. The labor and housing markets are still recovering, and inflation pressures are almost nonexistent. Meanwhile, the Fed has signaled they will continue to support the relatively fragile recovery for as long as necessary. In this environment, we expect interest rates to remain relatively range-bound over the next few months. The latest Fed policy decision has harnessed the momentum of rising yields, and, absent stronger economic data, longer-term interest rates should be relatively contained. On the other hand, it will be difficult for rates to rally substantially from here, as labor market conditions and housing market data would need to worsen materially.

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	**22** Average Years Experience	**12** 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 stock market continued its advance unabated at the start of the third quarter. But as interest rates continued their climb off the bottom, we saw stocks correct as fear that higher rates might choke off the economy crept back into the market. Then as investors returned from their summer vacations and economic data remained decent, the market once again resumed its upward climb. We saw a clear split between small and large cap returns near quarter's end, with small caps holding at record highs while large caps traded off modestly. For the full quarter large cap stocks held on to mid-single digit percentage gains, while small cap stocks were up in the double digits.

Large cap stocks had another solid gain in the third quarter, with the S&P 500 Index advancing 5.2% bringing the year to date return close to 20%. The more economically sensitive sectors such as Materials, Industrials and Consumer Discretionary posted the strongest gains, while the more defensive and higher dividend yielding sectors such as Telecommunication Services, Consumer Staples and Financials lagged. Small caps performed significantly better than large caps this quarter, with the Russell 2000 Index posting a double-digit return of 10.2%. This index is now up 27.7% year to date, or nearly 8 percentage points above large caps.

Looking forward, two issues loom large. As of this writing the government shutdown has just begun and investors are rightfully concerned about its impact on the market. The spending freeze will indeed hurt economic growth, but ultimately, as has happened many times in the past, the disagreements will be settled and the economic impact will dissipate. Should the lack of resolution on spending spill into the debate over raising our debt limit, we could indeed see greater economic impact and a sloppy stock market.

Tapering is the second major concern among investors. The Fed's decision to taper would be based on its perception of the sustainability of the economic recovery. Clearly the Fed does not view the economy as having improved enough yet to take such action. The Fed's commentary suggests tapering is less likely to begin soon, making the low interest rates associated with these accommodative monetary policies likely to continue for a more extended period of time.

While these issues are large and they are real, we believe investors should focus instead on the broad based evidence in support of continued economic growth. Home prices continue to increase, which has a positive impact on net worth, consumer confidence and spending. The uptick in rates has hurt mortgage volumes, and perhaps the level of new and existing home sales. This bears watching, as an important part of economic growth out of the recession has been the rebound in housing. Other indicators of economic growth include positive consumer, manufacturing and services survey results, improved industrial production, lower unemployment, reduced jobless claims, and solid retail sales. These positives have been achieved with minimal inflation.

> "Corporations continue to have solid profitability levels, moderate growth in earnings, and balance sheets flush with cash."

Corporations continue to have solid profitability levels, moderate growth in earnings, and balance sheets flush with cash. Uses of corporate cash for capital spending, acquisitions, dividends and share buybacks are all supportive of continued market advances. However, we must consider that the run in stock prices has pushed up valuations. While by no means at extreme levels, we are now trading at about 16 times expected 2013 earnings. We expect another year of moderate growth, suggesting that valuations looking out one year are at a more reasonable multiple of about 15½ times earnings. We would argue that such a valuation level is still attractive when compared to other investment alternatives, and to the historical relationship between stocks and interest rates.

Fund flows into equities remain positive and may act as a continued tailwind for equity performance. Our biggest concern is not really the level of markets; but the fact that complacency and risk taking tend to sneak into markets when they only go up. We indeed can see this in our analysis of factors driving this year's performance. So while we never enjoy it when the markets are down it would nonetheless be viewed as a healthy way to remove excesses from the market. And given our style of investing for the long term in high quality companies selling at reasonable valuations we would use any period of short-term market weakness to add to our favorite positions.

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