GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW

3Q 2014

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

While too many people around the world are living with turmoil and war, most Americans remain disinterested in world events, focused instead on their own problems, their own daily routines, their own financial concerns. There is a real disconnect with events happening beyond our shores. This attitude can be frustrating for those of us who feel a sense of responsibility to understand and even engage with the world.

It often takes flagrant actions to force changes in attitudes. The thought that NATO would create a large "Fast Response Force" and that member nations would consider increasing their defense spending up to 2% of their GDP in response to Russia's invasion of Ukraine is quite remarkable. Had Vladimir Putin been a little less pugnacious, I believe NATO would have been like the frog in hot water, passive and unconcerned, until Putin had achieved his goals. There are parallels to ISIS. Beheading innocent people makes it impossible for governments to avoid facing the crisis. I remember the disturbing photograph of a South Vietnamese general executing a Viet Cong

Continued on inside

INDEX PERFORMANCE *9/30/14*

	CURRENT QUARTER	YEAR TO DATE
Barclays 10-Year Municipal Bond Index	1.46%	7.24%
Barclays Aggregate Bond Index	0.17%	4.10%
Barclays High Yield Index	–1.87%	3.49%
Dow Jones Industrial Average	1.87%	4.60%
S&P 500 Index	1.13%	8.34%
Russell 2000 Index	–7.36%	–4.41%
NASDAQ Composite	2.24%	8.56%

THIRD QUARTER 2014 MARKET OVERVIEW

ECONOMY

- After contracting –2.1% to begin the year, GDP grew 4.6% in the second quarter as consumption and business investment strengthened.
- The economy continued to progress in the third quarter evidenced by decent job growth. The increase in nonfarm payrolls averaged 224,000 per month and the unemployment rate fell from 6.1% to 5.9%. Job growth, however, lagged the previous quarter and the labor force participation rate remains low at 62.7%.
- The ISM Manufacturing and Non-Manufacturing reports, already in expansion territory, increased, indicating robust activity across the manufacturing and service sectors. New home sales rebounded over the summer after declining in June.
- Inflation indicators appear contained and have been running below the Fed's target of 2%.

FED ACTION

- The federal funds target rate remains unchanged at 0–0.25%. In their September meeting, the FOMC retained the "considerable time" text regarding rates, also continuing to note the "significant underutilization of labor resources." Despite improvement in the labor markets, concerns remain about stagnation in real wages.
- As expected, the Fed continued to decrease its monthly bond purchases and is scheduled to end the program in October.
- Market participants are anticipating the first rate hike for the middle of 2015. There is a lack of consensus regarding how quickly rates will rise, as FOMC forecasts indicate rates will increase more aggressively than the market is pricing in.

BOND MARKETS

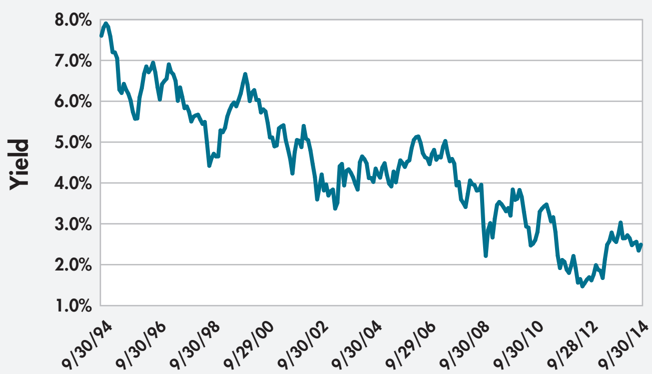
- Fixed income markets confounded investor expectations once again, as the generally positive tone of economic data failed to shift investor focus away from worries about geopolitics and slowing global growth. The 10-year and 30-year Treasury rates dropped 4 bps and 16 bps, respectively.
- Five-year rates rose 13 bps reflecting market worries of an early Fed exit. As a result, the yield curve continued to flatten with 2–30 year spreads hitting 2-year lows.
- Municipal bond rates continued to decline across most of the curve. Ten-year AAA municipal rates dropped 9 bps during the period to 2.17%, while 30-year rates fell 19 bps to 3.09%.
- Municipal bonds outperformed Treasuries, supported by strong technicals including limited supply and solid demand that saw oversubscriptions for new issuance.

EQUITY MARKETS

- While the U.S. economy showed steady growth and second quarter earnings came in stronger than expected, the equity markets struggled to advance, and stocks closed the third quarter with mixed results. For the fourth consecutive quarter, larger cap stocks outperformed, further extending their performance advantage over small caps.
- Sector leadership rotated again with Health Care, Technology, and Telecom posting the largest gains. In a complete reversal of second quarter trends, Energy was the worst performing sector, as global growth slowed, the dollar strengthened, and oil prices fell.
- Flows into equity funds turned negative as valuation concerns, particularly in the more volatile small cap market, continued to weigh on investors. The valuation disparity between large and small caps has compressed, and small cap valuations look more reasonable as we enter the fourth quarter.

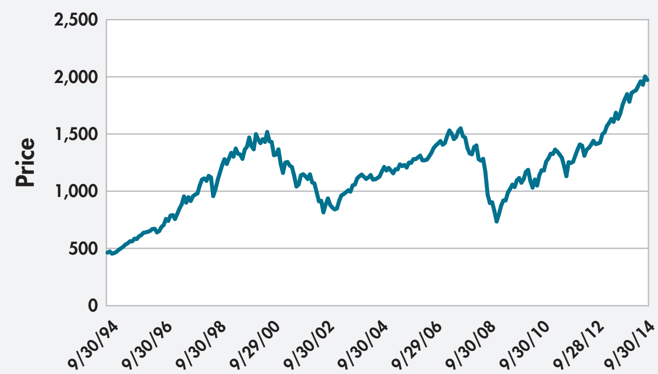
ECONOMIC COMMENTARY, continued from page 1

10-YEAR TREASURY RATES—LAST 20 YEARS



Source: Bloomberg

S&P 500 INDEX LEVEL—LAST 20 YEARS



Source: Bloomberg

prisoner in 1968. The image appeared on the front page of newspapers around the country and public opinion against the war became overwhelming.

Americans seem to be on a different planet. Very few understand what is happening around the world, and even less care. Obviously there are subsets of our population with great passion, but unfortunately, the majority, interested only in their lifestyle, need horrific images to sway their attitudes.

The irony of these times is that our domestic scene is quiet. The economy plugs along at 2%–3% growth, unemployment drifts lower and family incomes stagnate. Interest rates, both short- and long-term, remain low. Stocks drift higher. The little we hear out of Washington is mere political squabbling. We all hope for legislation to address the country's many structural problems, such as underinvestment in infrastructure, swelling entitlement programs and tax code complexities, but that won't happen anytime soon.

So what should you do with your money? How do you approach investing in a complicated world of fully valued markets?

I see established trends continuing. The Middle East will continue to boil, Putin won't change, and the areas of the world that are growing will continue to grow. Money will continue to move into the U.S. as a haven of relative calm. Here in Boston, a real sleeper among leading U.S. cities, we are becoming less provincial, our world class medical institutions and universities becoming an increasing draw for the aging wealth around the world. This will lift our real estate market and boost our local economy, a reminder that opportunities never disappear, they just move to unexpected quarters.

But, even so, we can no longer expect the consistent returns on stocks, bonds and real estate that existed in the past. As values increase, returns on investments decrease. Like bonds today, the future will hold lower rates of return for most asset classes. But low returns are better than no returns. We can't simply wish for better times and move to the sidelines, as so many have sat out the equity bull market of the last five years, and the bull market in bonds the last twenty. Cash (liquid assets) is never the answer. Sitting in cash is like refusing to get out of bed in the morning, afraid of facing the day.

I have been hammering away at the same themes for a long time now but in a slowing, mature, debt-ridden economy, you need to continue to seize opportunities and be willing to accept decent returns with some volatility. The world stage is not going to be an easy place.

We should be thankful for our protected continent, but we need not be isolationists. We can invest here and abroad because the world has many opportunities. We need to think globally as we live locally. A successful investor always looks ahead, focusing on inevitable change and development. Obsessing on today where the only answer appears to be hiding in cash is no way to build wealth. Running away from the present problems in the world only creates losses. Being "safe" doesn't exist. Either one is out front or left behind—there is nothing else. I find too many financial institutions are willing to protect the status quo, too comfortable investing for safety and predictability. That is too bad because it removes the responsibility given to them of trying to invest for the future.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE *9/30/14*

TOTAL ASSETS UNDER MANAGEMENT	$21.4 Billion
TOTAL EMPLOYEES	104
TOTAL INVESTMENT PROFESSIONALS	34

GW&K HIRES INTERNATIONAL EQUITY TEAM

Reid Galas, CFA, Vice President, Equity Portfolio Manager
Karl Kyriss, CFA, Vice President, Equity Analyst

Building upon GW&K's established track record in domestic small cap equity management, we recently hired Reid Galas and Karl Kyriss to develop an international small cap strategy. With more than 20 years combined experience in the investment and research of global stocks, they will be an excellent complement to our already strong team of domestic equity professionals. They share our long standing philosophy of in-depth fundamental research, seeking out quality, and investing for the long term and will add an important global perspective to our economic and investment strategy discussions.

NEW FIXED INCOME PROFESSIONAL

Christopher Iovanna, CFA, recently joined GW&K as Vice President and Fixed Income Specialist. As a member of our municipal and taxable bond investment teams, Chris works closely with portfolio managers and analysts to support the firm's client service and business development efforts. This position reflects our core commitment to educating clients, providing quality service, and offering accessibility to our investment teams and process.

Visit **www.gwkinvest.com** for more information.

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

14 Municipal Investment Professionals	**17** Average Years Experience	**12** Average Years with Firm

"…municipals still offer compelling after-tax value and a high quality buffer against increasing volatility. The unique dynamics of a retail-dominated buy side and an immensely diverse group of municipal issuers present opportunities to exploit."

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 a third consecutive quarter of solid returns, driven mostly by the combination of low supply and accelerating demand for tax-exempt paper. Third quarter issuance dropped to its lowest level in thirteen years, trailing even the anemic pace of last year, which was held back by the disruption from the taper talk. Meanwhile, demand surged, pushed higher by the need to reinvest seasonally high coupon and maturity payments. When new deals hit the market, investors clamored for allocations, leading to large oversubscriptions and lowered yields during order periods. As bonds became free to trade, investors in the secondary market only reinforced the trend, bidding up prices to get in on the action. This dynamic, in place all quarter, helped municipal bonds outperform the Treasury market at every major point on the curve.

But even with municipal bonds plugging along in the outer realm of the fixed income kingdom, they were still heavily influenced by the larger forces at work in the broader markets. The Treasury curve underwent a massive flattening during the quarter, with 5-year rates rising 13 basis points while 30-year rates dropped 16 basis points. A steady dose of encouraging economic data led the short end to more aggressively prepare for the Fed's first rate hike while the long end was supported by falling global inflation, persistent geopolitical unrest and the pull of rock-bottom yields in Europe and Japan. The municipal curve followed the flattening trend, but not nearly to the same extent. The divergence came at the short end where retail's preference for short paper pushed 5-year tax-exempt yields down 3 basis points for the quarter, the opposite direction of their taxable counterparts. Yields in 10 and 30 years, meanwhile, declined 9 and 19 basis points, respectively, outdistancing the same points on the Treasury curve.

Municipal credit spreads tightened during the quarter, ignoring the more widespread "risk off" sentiment in the taxable market. High yield municipal bonds led the way, up over 5% for the quarter largely due to an upswing in Puerto Rico paper, which now dominates the space. The appetite for yield trickled down to the investment grade universe despite notable downgrades to Pennsylvania, New Jersey and Kansas. All three states suffered from their poor handling of pension obligations, though only New Jersey spreads saw a meaningful widening. But as the equally high profile upgrade of New York State demonstrated, there are cross currents at work in the municipal bond market and solid fundamentals continue to be the rule, rather than the exception.

With demand outstripping supply throughout the quarter, the resulting spread compression created an environment of minimal credit differentiation across issues. We took the opportunity to sell a few names that were fully priced based on their credit metrics and outlook. We focused on some weaker state GOs, selling at levels that failed to factor in potential downside. With the coming changes to pension accounting reporting for fiscal 2015, the headline risk for states that fail to adequately address their problems could be meaningful. We felt it best to get ahead of any prospective spread widening. We also continued to target 5-year maturities, and reinvested proceeds in 8–13 year maturities in order to take advantage of the yield pickup and roll benefits of a still historically steep curve. A modest backup in rates and a temporary supply spike in September provided the appropriate platform to execute these trades.

The resiliency of the municipal bond market may be put to a test in the coming months. We are entering a period that typically brings higher new issue supply at a time the broader market is focused on the termination of quantitative easing and the timing of the Fed's first rate hike. But municipals still offer compelling after-tax value and a high quality buffer against increasing volatility. The unique dynamics of a retail-dominated buy side and an immensely diverse group of municipal issuers present opportunities to exploit. We have always emphasized flexibility in our portfolio construction, which is especially critical in times of uncertainty. We will continue to make adjustments, reacting to changes in the curve, rates, and spreads. We will focus on protecting the downside, capturing growth opportunities and adapting to inevitable changes as they occur.

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	**17** 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

Fixed income markets defied expectations once again in the third quarter, as positive economic data failed to neutralize worries about Fed rate hikes, geopolitics, and global economic growth. The quarter started out on a high note, with strong payroll data challenging the flight-to-quality narrative in place all year. But any worries about higher rates were quickly put to rest. Macroeconomic concerns returned to the forefront, and interest rates resumed their steady march lower. This reversal would repeat itself several times, as invariably each piece of good news (better-than-expected GDP growth, strong housing data, moderate language from the Fed) was followed by something negative (disappointing payroll numbers, deflation in the Eurozone, military actions in the Middle East). As a result, and despite plenty of volatility, interest rates ended the quarter close to where they began.

The yield curve flattened to a level last seen in early 2009. Short rates rose to their highest level in over a year on improving economic data, while the long end continued to rally due to a combination of the attractiveness of relatively high-yielding U.S. debt, benign inflation expectations, and moderate growth assumptions. The Treasury sector overall returned 0.34%, outperforming the 0.17% return of the Barclays Aggregate Index.

Investment grade corporates posted a slightly negative return of –0.08% for the quarter, their income nearly enough to offset the impact of rising rates and wider spreads. High quality outperformed during the period, and the worst performers were BBB bonds at –0.21%, followed by single-As at –0.02% and AAs at 0.18%. High yield was also weak, on the back of especially poor performance among the lower quality credits. Overall, the high yield sector returned –1.87%. Within the government-related sector, taxable municipals were among the strongest performing bonds due to their long duration, returning 0.65%.

We expect market volatility to remain elevated. Investors will continue to parse every release of economic data in an effort to predict the exact timing of the Fed. As the date of the first rate hike approaches, the short end of the curve should remain under pressure, while the longer end should benefit from low inflation expectations and demand for the safety and relative attractiveness of U.S. debt. In addition to the prospect of higher rates, geopolitical tensions and global growth concerns will weigh on investor sentiment. Despite these risks, however, we maintain a constructive view of risk assets, as strong corporate balance sheets, an improving labor market, and ongoing (if slightly less robust) support from the Fed provide favorable conditions for spread product.

We are currently market-weight duration. Though we expect a modest rise in rates, particularly at the short end, we also expect to see the curve flatten, and therefore see value in the long end. We have maintained our preference for intermediate exposure because we believe the extra carry offers returns that more than compensate for the risk of rising rates at that part of the curve.

Investment grade corporates continue to offer attractive value, as their spread above Treasuries enhances returns and reduces exposure to rising rates. At 112 basis points, we think investors are being adequately compensated for the credit risk they are assuming, particularly given the strength of today's corporate balance sheets and the responsible financial policies among borrowers. Within the investment grade space, we continue to favor BBBs, which offer 46 basis points of spread relative to single-As for an acceptable level of additional credit risk. Additionally, we maintain our overweight exposure to the more cyclical sectors, which have been most significantly affected by negative sentiment and which we believe will be the largest beneficiaries of an economic recovery.

We remain overweight high yield in eligible strategies as well, given our expectation for low default rates, strong credit fundamentals, and continued demand for income. With high yield spreads at 424 basis points, their highest level in over a year, we believe both the carry and potential for spread compression offer attractive return potential and significant protection against rising rates. We remain neutral on mortgages, despite limited room for spread compression, because they offer a defensive alternative to credit markets.

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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

9 Equity Investment Professionals	**18** 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

It was a tale of two markets in the third quarter. The broad market was rather directionless throughout the period, ending with a modest gain. On the flip side, small cap stocks struggled from the start, with declines accelerating in September to finish the quarter down in the high single digits. This was the fourth quarter in a row where large caps outperformed, more than erasing last year's strong relative outperformance by small cap stocks. The economy showed good resilience, with the vast majority of economic news positive. Yet several international geopolitical and economic factors ranging from Russia's aggressive behavior, to conflict in the Middle East, Ebola in Africa, and slower economic growth in both China and Europe, seemed to have the upper hand as investors shunned risk and reduced their exposure to equities. So while we acknowledge the list of global concerns, the general trends toward moderate economic growth, low inflation and low interest rates would still argue for a positive stock market outlook in the quarters ahead.

The relative performance gap between large and small cap stocks continued to widen, with large beating small by 12.8% year to date. And the gap this quarter, at 8.5%, was the largest since the internet bubble period of 1998 and 1999. We would attribute this to a reversal of last year's terrific gains in small caps which pushed valuations above their long-term averages. As this valuation gap has now substantially closed, we are expecting more comparable performance among stocks of various sizes.

Our strategies all posted losses this quarter primarily due to the weak returns of small cap stocks. It was generally a risk-off quarter, which helped our small cap strategies relative to their benchmarks given the higher-quality nature of our holdings.

Our stock market outlook is still quite constructive despite the quarter's rather anemic stock price performance. While geopolitical events are creating a tremendous amount of headline risk, the overall economic backdrop remains positive. The list of positive indicators is quite long: jobs creation remains solid, the unemployment rate continues to tick down, the ISM Services and Manufacturing surveys are comfortably in expansion territory, and the Consumer Confidence Index reflects favorable spending expectations. We recognize that all of the economic data isn't positive. Slower economic growth outside the U.S. could impact the more export-oriented sectors of our economy. And new and existing home sales data remains sluggish even though home prices continue to advance.

The interest rate outlook appears to have created the greatest uncertainty among investors. While the Fed has made it clear that it will keep rates low until the U.S. recovery is considered self-sustaining, investors have already begun to anticipate higher rates. Perhaps this factor alone explains the more volatile behavior of stocks. Yet we see few signs of either inflation or excessive growth that would likely preclude higher rates. Indeed, inflation remains very tame around the globe, commodity prices continue to fall, and the strong dollar will make our imports less expensive. All these factors suggest medium- and long-term rates will likely stay low regardless of Fed activity. Yet none of this has kept investors from pulling a substantial amount of money out of equities, especially among smaller cap equity funds. While we cannot control investor behavior, we feel outflows will reverse themselves once investors focus on the relative attractiveness of stock prices.

Corporate profitability showed good improvement last quarter, and we expect good profit growth again this quarter. And the market continues to sell at a price/earnings ratio of under 16½ x 2014 estimated earnings. With earnings growth expected to continue, the market sells at a very reasonable 15½ x forward 12 months earnings. So as stock prices correct and interest rates stay rather benign, we believe stocks remain attractive relative to fixed income alternatives. If stock prices were to have a meaningful correction, corporations have the cash flow and debt capacity to continue with share buybacks, acquisitions and dividend payments as ways to enhance value for their shareholders.

We view ourselves as stock pickers, and regardless of the market's direction, our intent is to find well-managed companies with a record of consistent and sustainable growth that we can buy at reasonable valuation levels and hold for the long term. As such, we do not react to a market correction with fear; rather we use the opportunity to add to our favorite names at even better prices.

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