GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 3Q 2012

ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

I hate to be the bearer of good news but, believe it or not, the economy is doing pretty well and the stock and bond markets have been enjoying extraordinary returns. As of this writing, for instance, the S&P 500 is up more than 16% for the calendar year and 30% for the last 12 months. You would never know that if you only listened to the talk shows.

And you also wouldn't know it if you only listened to the politicians. Last quarter I wrote of the three-ring circus in Washington where entrenched ideologies recoil from compromise and tough choices. Now that we have the conventions behind us, I believe we can add those stump speeches to the circus environment. All we heard were feel good platitudes from politicians afraid to make a mistake. So now it is a four-ring circus where each candidate hopes the other shoots himself in the foot and neither feels the need to discuss real issues. I was disappointed by both conventions. There were a few interesting speeches by non-candidates but the nominees' speeches said little on which to reflect. Romney is hoping the economy trips up and Obama believes that if he keeps his campaign simple he will win. I am hoping the debates will encourage candidates to openly discuss issues and take positions. The voting public will continue to get barraged by competing narratives that disagree on where to lay blame but seem to agree that the present situation is a mess. And yet the markets roar ahead.

Continued on inside

INDEX PERFORMANCE *9/30/12*

	CURRENT QUARTER	YEAR-TO-DATE
Barclays 10-Year Municipal Bond Index	2.13%	4.87%
Barclays Aggregate Bond Index	1.58%	3.99%
Barclays High Yield Index	4.53%	12.13%
Dow Jones Industrial Average	5.02%	12.19%
S&P 500 Index	6.35%	16.44%
Russell 2000 Index	5.25%	14.23%
NASDAQ Composite	6.51%	20.65%

THIRD QUARTER 2012 MARKET OVERVIEW

ECONOMY

- Broader market sentiment bounced between signals of further global weakness and the promise of aggressive monetary stimulus as the ECB committed to preserve the Euro and the Fed announced plans of QE3 (see Fed Action comments).
- The employment reports were generally disappointing as the nonfarm payroll reports showed weak employment growth.
- In a continuing trend, slowing global growth led to weaker domestic and international manufacturing data.
- Due to record low mortgage rates and early signs of banks' increased willingness to lend, the domestic housing market continues to stabilize and recent data show signs of a modest recovery.

FED ACTION

- The FOMC left the target range for federal funds at 0-0.25% and maintained its commitment to keeping the rate at exceptionally low levels at least through mid-2015. The Fed also continued its maturity extension program "Operation Twist" through the end of 2012.
- The FOMC noted that strains in global financial markets posed significant downside risks and expressed concern that economic growth may not be strong enough to substantially improve the labor market.
- In an effort to provide additional monetary stimulus, the Fed announced plans to purchase $40 billion in agency mortgage-backed securities (MBS) per month indefinitely until labor markets improve.
- The Fed noted that although some key commodity prices had risen recently, overall inflation remained subdued.

BOND MARKETS

- 5-year and 10-year Treasury yields declined modestly while 30-year yields rose seven basis points. In response to aggressive central bank stimulus pledges by the ECB and the Fed at the beginning of September, Treasury yields spiked higher only to revert back to their pre-announcement levels when investor focus returned to the broader macroeconomic environment.
- High grade and high yield corporate bonds performed well as credit spreads narrowed significantly due to increased central bank activity. Mortgage-backed securities also enjoyed a strong quarter as the Fed's MBS purchase program resulted in a dramatic spread tightening.
- Municipal bonds posted solid returns and outperformed Treasuries as a meaningful drop in issuance was met with strong investor demand.

EQUITY MARKETS

- In spite of the continuing strains on domestic and global growth, 2012 has turned into a respectable year so far for equity investors. Stocks posted solid 3Q returns and have turned in impressive double-digit gains for the year-to-date period.
- Gains were registered by all sectors except Utilities, a defensive sector that typically underperforms in solid markets. Energy was the strongest sector, following the rise in oil prices, and economically sensitive sectors such as Information Technology and Consumer Discretionary also showed solid gains.
- Large cap stocks have maintained their performance advantage over small caps for the quarter and the year to date, with very strong performance among the largest blue-chip technology names largely contributing to this difference.

ECONOMIC COMMENTARY, continued from page 1

What creates this disconnect between economic reality and what we read in the daily news, what candidates say, and what we hear on daily talk shows? Can the market be so out of step with our society? Has Wall Street once again become a casino? The answer to all these questions is No. Wall Street has it right and the media and politicians have it wrong. Some believe that all the credit goes to the Federal Reserve, which has created liquidity and kept short-term rates near zero. There is no doubt that accommodative monetary policy, in the absence of any fiscal policy, has provided an important tailwind to the recovery but that is only a partial answer.

So why then are markets so strong? The answer is "the economy, stupid." And how can that be with unemployment so high, growth sluggish, and the international economy slowing? Because, while parts of the economy are shrinking, other, more vital areas are growing. Yes, the public sector is losing jobs. But the private sector is adding jobs. The private sector is also benefiting from productivity gains in manufacturing, technological advances and in many cases a standard of excellence in management. The Wall Street Journal stated that profits at domestic manufacturing companies are running at an annual rate of $363 billion this year versus $290 billion five years ago (before the meltdown). The private sector is also not restrained by borders. While the public sector is purely domestic, the U.S. private economy taps into the world economy which, though slowing, is still expanding. International competition demands a high standard of excellence pushing companies to grow efficiencies. The public sector does not face the same competitive demands.

I am not sure that the voting public appreciates how private sector success is helping overall America, not just for Wall Street and stock markets, which seems to be the popular opinion, but for the general good of all. Money invested in businesses provides the grease for the system. This country's ability to raise capital for new ideas allows us to improve the life of those who are employed and those who benefit from products. Companies are not the enemy; they are the engine of growth, employment, products, research and development. Every state tries to encourage businesses to build in their area. Why? Because business capital, made available by those who can afford to invest, becomes the engine of regional growth. Yes, the investor often does well, but so does the company and those employed and, as importantly, so does the city and state. It is not a battle between public and private sectors, it is a partnership. The better the private sector does the better the choices of the public sector. It was the U.S. that wisely encouraged and promoted the economy that allowed capitalism to flourish. We in America believe that 1+1 can sometimes be greater than the sum of its parts. We encourage competition, knowing competition breeds excellence.

My prediction is that as most slumber, a few will see opportunity. Years from now cynics will describe those who were successful as lucky or selfish, but in fact they will be neither. They will have acted on their "optimism." The optimists will win these investment battles and the despondent will wake up in five years and ask: where was I when these opportunities existed? The answer: you were sleeping.

This government, regardless of how the election turns out, will find its way to reasonable laws. Future policy will be far from perfect and not totally "fair," but the edges will come closer together and the middle will reign as it always does. So don't lose faith in the system as you watch the political combatants. Don't miss the opportunity to take part in the solution. Let your money talk by buying tax-exempt bonds that fund roads, schools and public utilities, corporate bonds that allow companies to lessen their dependence on banks and increase their ability to grow, and/or stocks that create the foundation for corporations to invest in business and people. All your investments help the middle class because it is through private financing that jobs are created.

I want to point out that the income generated from municipal bonds is not taxed, and for stock dividends the federal tax rate is 15%. Many of you are in the 15% tax bracket if most of your income is generated by investments. In fact, it is our job to keep you in or around the 15% tax bracket. It is not a crime to keep brackets low, the tax code accommodates it.

As in all healthy relationships, the private and the public sectors should exist in harmony. But when they are out of synch, don't blame one or the other.

Keep the faith.

Harold G. Kotler, CFA
Chief Executive Officer
Chief Investment Officer

GW&K UPDATE

TOTAL ASSETS UNDER MANAGEMENT	$16.2 Billion
TOTAL EMPLOYEES	93
TOTAL INVESTMENT PROFESSIONALS	30

INTRODUCING OUR NEW BRAND—INSPIRED BY OUR CLIENTS

Client relationships are central to this firm. We are committed to being accessible and delivering outstanding service every time. Working side-by-side with clients fuels our best thinking—it gives us more opportunities to listen, rethink and improve.

Relationship is so important to us that we have decided to acknowledge it in a public way. Our logo and communications will emphasize the Ampersand. To us—and we hope to you—the Ampersand will symbolize the role our clients play in making GW&K strong and capable. If there is one thing we have learned, it is that nothing works as well as working together.

The Ampersand also stands for the added value our clients tell us they receive at GW&K: exceptional people, investment discipline, market insights, innovation, a collaborative approach and meticulous service.

None of what we have built since 1974 would have been possible without clients like you. Thank you for doing business with GW&K.

Harold G. Kotler, CFA

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. Touringy, CFA	Partner, Portfolio Manager
Brian T. Moreland, CFA	Vice President, Portfolio Manager

21 Fixed Income Investment Professionals	**18** Average Years Experience	**12** Average Years with Firm

GW&K MUNICIPAL BOND STRATEGIES

MUNICIPAL ENHANCED YIELD	Long-term approach that includes an allocation to higher yielding bonds with a goal to produce high after-tax income
MUNICIPAL BOND	High quality intermediate approach with goal to preserve and enhance capital emphasizes research and active management
FIVE-YEAR MUNICIPAL BOND	High quality active approach aims to preserve and enhance capital and targets a duration to maturity of 5 years
SHORT-TERM MUNICIPAL BOND	Seeks to earn higher after-tax returns than money market funds while managing risk

Municipal bonds posted solid returns in the third quarter thanks to a strong technical environment. A meaningful drop in tax-exempt issuance was met with a swell in demand leading to gains that easily surpassed the mixed results experienced by Treasuries. During the quarter, broader market sentiment bounced back and forth between signals of further global weakness and the promise of aggressive monetary stimulus. In late July, bond yields broke through their lows from the 1940s as the sovereign crisis in Europe flared up and domestic manufacturing data suggested a stalled economy at home. In mid-September, after the Chairman of the European Central Bank vowed to do “whatever it takes” to preserve the Euro and the Fed announced QE3, yields surged as the bond market briefly considered the inflationary effects of such open-ended stimulus programs. Over the following two weeks, however, the market again focused on the negatives and Treasury yields ended the quarter mixed, down modestly inside 10 years and up slightly at the long end.

Because tax-exempt yields began the quarter at levels that were already higher than Treasuries, substantial room existed for municipals to outperform their taxable counterparts. Mutual fund flows, which had been positive all year, continued strong through the summer months. When new issue supply dipped, as it normally does this time of year, buyers fought over the smaller volume of bonds, sending municipal yields lower. This was especially the case on the long-end where supply plummeted due to the high percentage of refunding deals, which are dominated by intermediate maturities.

> “Because tax-exempt yields began the quarter at levels that were already higher than Treasuries, substantial room existed for municipals to outperform their taxable counterparts.”

For the quarter, while 10-year municipal yields decreased 16 basis points, 30-year municipal yields dropped 31 basis points. In this environment each of our municipal bond strategies outperformed their respective benchmarks. A slightly longer duration relative to the index helped our performance as rates moved lower.

Although technicals were clearly the driving factor behind third quarter performance, a backdrop of improving credit quality should not be dismissed. While the headlines are still obsessed with covering a few high profile pockets of distress, default rates are actually running behind last year’s already very slow pace. Instead, evidence continues to mount of a slow but steady recovery.

Looking ahead to the fourth quarter, the outlook becomes a little cloudier. The technical environment is ready to shift from a summer tailwind to a fall headwind. We expect supply to pick up noticeably and it could come as soon as the next few weeks. The strong coupon and maturity redemptions of June and July have already been reinvested. Flows into tax-exempt mutual funds have shown early signs of slowing. Yields ended the quarter only 10 basis points above their all-time lows and October has rarely been kind to the bond market. Add in the wild cards of a presidential election, a looming fiscal cliff and the uncertainty of tax reform and there are plenty of reasons for caution.

In an environment of uncertainty, however, the municipal bond market is one of the few asset classes that should provide stability and predictability. The slow improvement in tax collections and the aggressive cost cutting at all levels of government have reinforced the historical status of municipals as a haven against broader market volatility. Yield ratios against Treasuries remain at or above 100%, providing a cushion against a rise in rates. The retail makeup of the lending base and the essential nature of the infrastructure being financed should ensure that policy makers will consider carefully before tinkering with the municipal tax exemption. Meanwhile, the Fed seems determined to hold down rates for the foreseeable future placing greater emphasis on maximizing roll and carry. Heading into the fall, we will position portfolios to take advantage of the steep curve and any trading opportunities that arise from increased volatility.

As we head into the fourth quarter, the front-end of the yield curve is still anchored by the Fed, so we will continue to take advantage of the resulting steep yield curve environment. But, with rates at near historic lows and a potentially weak technical environment, we must consider the potential for higher yields in the fourth quarter. With approximately 30% of our portfolio shorter than the index, we are prepared to take advantage of any such seasonal or more broad-based shift in the curve. These 5–7 year bonds are the defensive part of the portfolio that can and will be redeployed out longer should rates rise. We patiently await such an opportunity.

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Taxable Bond Team Leader
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Schuyler S. Reece, CFA	Portfolio Manager

21 Fixed Income Investment Professionals	**18** Average Years Experience	**12** Average Years with Firm

GW&K TAXABLE BOND STRATEGIES

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

As macroeconomic data from around the globe continued to disappoint, the world's major central banks stepped in again to fight the ongoing economic malaise with formidable unconventional policy actions. Determined to harness borrowing costs for the European periphery, the European Central Bank (ECB) announced an aggressive bond buying program to signal its firm commitment to controlling the evolving debt crisis in Europe and preserving the monetary union. Equally, if not more, important was the Federal Reserve's (Fed) announcing that it would continue Operation Twist through year-end, extend its zero-interest rate environment until at least mid-2015, and commence large-scale purchases of agency mortgage-backed securities until the FOMC sees significant improvement in the U.S. jobs market. This was the first time that the duration of a stimulus program was linked to a tangible economic target.

With global monetary policy supportive of financial stability and the convalescence of sovereign, corporate, and consumer debt burdens, we enter the fourth quarter with a constructive outlook. The promise of such broad stimulative measures should provide a powerful, near-term boost to risk assets, such as equities, credit, and housing, and set the stage for much needed improvement in consumer confidence, wealth, and, most importantly, spending.

"With global monetary policy supportive of financial stability and the convalescence of sovereign, corporate, and consumer debt burdens, we enter the fourth quarter with a constructive outlook."

Following the positive developments in Europe and in widespread anticipation of further quantitative easing from the FOMC, risk assets rallied aggressively. As tail risk from a disintegration of the currency union subsided, investors piled into the corporate sector for the additional spread above the paltry yields found in the Treasury sector. Corporate bonds were the clear outperformer within the taxable bond market, as spreads tightened to their richest levels of the year. For the quarter, high yield and high grade corporate bonds returned an impressive 4.53% and 3.83%, respectively.

Mortgage-backed securities also enjoyed a strong quarter, returning 1.13%, as the Fed's announcement of QE3 resulted in a dramatic spread tightening. Despite option-adjusted spreads plummeting to 24 basis points over Treasuries, we believe that the sector offers an attractive incremental yield relative to front-end Treasuries.

The Treasury market traded in a choppy range during the quarter and ultimately returned 0.57%, as the market swung between the euphoria of massive central bank intervention and the reality of listless economic data.

In this environment, each of our taxable bond strategies delivered strong relative results, outperforming their respective benchmarks. Results were driven mainly by positive security selection among corporate bonds and an underweight to Treasuries.

The surprisingly strong monetary interventions announced by the Fed and the ECB keep us comfortable with our constructive position toward spread product, and, in particular, corporate bonds. While the macro landscape remains challenging, we expect global growth to stabilize over the next few months and believe the Fed's aggressive liquidity injections create an important price floor for the market. Likewise, the ECB's July interest rate cut and pledge to support front-end sovereign rates have been effective in curtailing risks surrounding the European crisis. Looking forward, continued central bank actions along with modest economic growth should keep global risk-free rates low, tail risks minimized, and volatility contained—all factors which support our modestly aggressive positioning.

With rates hovering near record lows and negative real yields across most of the Treasury curve, we continue to underweight the Treasury sector. We continue to favor the corporate credit market as an excellent source of carry and for its potential for further excess return, albeit at nowhere near levels realized thus far this year. Fundamentals for corporate debt are still attractive, as margins remain relatively high, the earnings outlook is constructive, the expected default environment is benign, and issuers continue to lock in low-cost long-term financing. Although valuations are closer to fair value after the recent rally, we think that the combination of low growth and a repressed interest rate environment should allow spreads to move through their long-term averages to levels nearer pre-crisis tights. We continue to hold a relatively neutral exposure to the mortgage sector. While yields are low and spreads tight, both could easily continue to move lower in the coming months as investors compete with the Fed for scarce MBS supply.

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

SMALL CAP GROWTH	Utilizes fundamental research and quantitative screening to identify small companies with sustainable, above-average earnings growth in niche markets
SMALL CAP EQUITY	Focuses on small companies with sustainable earnings growth in niche markets with lasting growth potential
SMALL/MID CAP EQUITY	A core strategy that invests in both small and medium sized companies that offer sustainable earnings growth
DIVERSIFIED EQUITY	Combines growth & value disciplines and diversifies across large, mid, and small capitalization stocks
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

The first three weeks of the third quarter got off to a rough start, driven by the continued European crisis, sluggish economic data out of China, slowing U.S. jobs growth, and a slowdown in corporate earnings growth. Then market conditions changed on a dime once the European Central Bank (ECB) expressed its commitment to injecting liquidity into Europe thus sustaining the Euro. And then, contrary to many expectations, weaker economic news in the U.S. further extended the rally as equity buyers anticipated the next round of easing by the Federal Reserve (Fed). Of course, the market got its wish with the Fed's announcement of QE3 in September, and stocks immediately began to backtrack! Amid these market gyrations driven more by macro considerations than stock specific news, it may have been hard not to miss that equities posted solid mid single-digit returns for the quarter.

Large cap stocks, as measured by the S&P 500 Index, advanced 6.35% in the quarter. Gains were registered by all economic sectors except Utilities, a defensive sector that typically underperforms in solid markets. Energy was the strongest sector following the rise in oil prices. Economically sensitive sectors such as Information Technology and Consumer Discretionary also showed solid gains in the high single digits.

> "We continue with our positive market outlook despite sluggish global economic growth. The primary underpinning of our positive thesis is the concerted global effort by central banks to provide massive levels of liquidity into the financial system."

Small cap stocks also performed admirably in the third quarter, with the Russell 2000 Index gaining 5.25%. All small cap sectors registered gains in the quarter, with no particular theme among the best and worst performing sectors.

Large caps stocks have maintained their performance advantage over small caps in both the third quarter and year to date, with very strong performance among the largest blue-chip Technology names explaining most of this difference.

We saw gains in the mid single digits across our equity strategies in the third quarter. Our smaller cap strategies did particularly well, outperforming their benchmarks by about one percentage point. We were especially pleased with this relative performance since our lower-volatility, quality-oriented investment process has historically lagged during "risk-on" periods such as the one experienced this quarter.

We continue with our positive market outlook despite sluggish global economic growth. The primary underpinning of our positive thesis is the concerted global effort by central banks to provide massive levels of liquidity into the financial system. The Fed, the ECB and China have all given the markets what they were looking for: indications they will do whatever is necessary though monetary policy to keep countries and markets moving in a positive direction. Such injections of capital, along with their resulting low interest rates, are highly correlated with both economic growth and stock market advances. While we are also experiencing higher commodity prices, there is not yet solid evidence that this is leading to broadly higher inflation. We concede inflation is a possible outcome of aggressive monetary stimulus, and will be diligent in looking for signs of it.

Of course we must also address the looming "fiscal cliff" which will occur if new tax legislation is not enacted before year-end. We believe both parties in Washington understand how disastrous this would be to our economy, and we are hearing from many sources that the two parties are already in negotiations to agree on a compromise and thus avert a crisis.

The impact of the world's problems on our economy is not immaterial. Corporations are no doubt seeing sluggish overseas demand and must be pulling in their hiring and spending plans. Yet corporate profitability remains strong, although year-over-year growth has decelerated. Corporate cash balances and balance sheet quality also remain high. In the manufacturing space, we have indeed seen things slow over the last few months. This is also evident in the rather anemic jobs data. However, the ISM Manufacturing index has most recently just gone above 50, signaling we should be back in an expansionary phase. Other signs of economic growth are numerous, including positive turns in housing and consumer confidence. As such consumer spending remains solid. So we remain believers in economic growth, albeit sluggish, and a long, slow path of economic recovery, sustained growth and rising stock markets.

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