GW&K INVESTMENT MANAGEMENT

YEAR-END INVESTMENT REVIEW 4Q 2012

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

How can we invest without knowing the rules of the road? How can we be sure that changes in the law will be long-term and not just temporary compromises? As investors, we never expect certainty, but we do expect rules with which to evaluate decisions. Over my forty-eight years in the business, I have witnessed countless tax law changes and the market has adjusted to them. This time will be no different. The only wrinkles in today's environment are the material changes that go beyond tax rates. In fact, tax rates are the least of our problems since most high earners would be happy to pay more taxes if the money was used to reduce the deficit and make necessary changes to this country's entitlement programs.

So I believe the issues are not tax rates but preference items. To what degree will our charitable gifts be deductible against income? Will state and local taxes be deductible? Will unearned income be taxed like earned income and will all unearned income be treated the same? Will tax-exempt bonds be fully tax-free or will there be limits? Will mortgage interest still be deductible and, if so, to what limit?

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INDEX PERFORMANCE *12/31/12*

	CURRENT QUARTER	YEAR-TO-DATE
Barclays 10-Year Municipal Bond Index	0.79%	5.70%
Barclays Aggregate Bond Index	0.21%	4.21%
Barclays High Yield Index	3.29%	15.81%
Dow Jones Industrial Average	–1.74%	10.24%
S&P 500 Index	–0.38%	16.00%
Russell 2000 Index	1.85%	16.35%
NASDAQ Composite	–2.65%	17.45%

FOURTH QUARTER 2012 MARKET OVERVIEW

ECONOMY

- Though the fiscal cliff debate created uncertainty, continued global monetary stimulus and a decline in energy prices resulted in modestly better economic data.
- The unemployment rate held steady at 7.8%; however weekly unemployment claims ended December at their lowest level since 2008.
- While manufacturing activity deteriorated during the quarter, a stronger December reading indicated a move toward modest expansion.
- Low mortgage rates, an improving lending environment and more positive consumer sentiment resulted in a pick-up in existing home sales and increases in home values across most of the country.

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 as long as unemployment remains above 6.5% and inflation stays below 2.5%.
- The Fed indicated that it will continue to purchase $40 billion in agency mortgage-backed securities (MBS) per month and it announced that it would begin purchasing $45 billion in Treasuries per month.
- Chairman Bernanke noted that besides some temporary energy related fluctuations, inflation remains low and is likely to remain at or below the FOMC's 2% target in coming quarters.

BOND MARKETS

- Five-, ten- and thirty-year Treasury yields were flat for most of the quarter before moving approximately 10 basis points higher in December on improving fiscal cliff sentiment and modestly positive economic data.
- High yield and high grade corporate bonds capped off a very strong year with solid returns as credit spreads narrowed as investors continued to search for yield. Mortgage-backed security returns were modestly negative as loan origination increased and some investors harvested gains.
- After the Presidential election, the municipal bond market rallied during November but sold off in December leaving quarterly returns modestly positive across most of the curve. Municipal yields closed 2012 at or higher than Treasury yields at every point on the curve except the long-end which should help mitigate negative reactions to talk of capping the municipal exemption in the federal budget debate.

EQUITY MARKETS

- After the equity market declined steadily in the first half of the quarter, the trend turned upward on the hope that the fiscal cliff would be avoided, improved housing data, the successful leadership transition in China, less concern for Greece, and comments from the Fed that quantitative easing and low rates would remain for an extended period of time.
- Equities ended the quarter pretty much where they began, with stocks flat to up modestly. Since the lows of nearly four years ago, the market has increased by over 100%.
- Sectors that are beneficiaries of economic growth, such as Industrials and Financials, were the performance leaders this quarter. The laggards were Technology and Telecommunications, where some of the largest cap names were particularly weak.

My problem with all this confusion is the stupid simplicity people assign to these decisions. The tax code is complicated for good reason. The government collects taxes to fund government activities and programs of course, but the structure of the tax code also serves to motivate and stimulate capital movement. Many people do not fully appreciate the success of our tax code. This country allows unlimited charitable deductions because the government does little to fund the arts, scientific research, religious institutions, educational organizations and many other interests that benefit from the generosity of Americans.

Mortgage deductibility has provided an important incentive toward home ownership, contributing to the wealth effect of middle-class America. Deductions allow capital to flow to areas that it would not otherwise go without the tax benefit.

The irony in all this confusion is that the private sector's health is intact. Personal debt is declining, household net worth is rising, corporations are flush with cash, the capital markets are both liquid and accessible, and the world's economies continue to grow.

So my attitude is: to hell with Washington. There is money to be made even though we cannot predict where or how. The key lesson now, as always, is diversification. Do not be stuck because our government is stuck. How can we invest without knowing the rules? Just invest. Returns may be lessened, fears and volatility may increase (or not)—so what? The world is moving forward with or without Washington. I do not want to sound too outrageous, but Harold Geneen, former President and CEO of International Telephone and Telegraph (one of the first conglomerates), once said that corporations are more powerful than governments. Even though this sounds a little scary, there is some truth in it. We have seen companies in Europe and Asia grow in spite of their governments. We have seen German businesses survive the Third Reich. Businesses are on a different playing field than governments. The only "ism" that has survived the 19th, 20th and 21st centuries is capitalism—why? It has no bedfellows. It does not care about ethnicity or religion or any other subjective considerations. It only cares about rates of return on capital. This "ism" is unstoppable. There are only a few cultures in the world that don't employ a return on capital as a guide to success. People want to be consumers; many in the Chinese elite are billionaires. The truth is most want the comfort of what consumerism brings, along with health and educational possibilities.

Government's role in capitalism can be debated and argued endlessly and I will not dive into that firestorm. The important message is, outside of wars and isolationism, capitalism will find opportunity and returns.

So it is the responsibility of those with capital and those who manage capital to figure out where to go with the money, how best to diversify, and through what means to achieve returns. Cycles come and go but there is always opportunity. I believe that the discouraging inability of our government to work together provides the perfect backdrop for real success. Remember the old adage that "markets climb a wall of worry." As I stated in my last economic commentary, there will be those who continue to look back and wonder how those who invested did so well in the face of confusion, and they will say that those who made money were very lucky. I say they understood the nature of the beast. As we end 2012 with double-digit returns, it is natural for many to continue to fear the unknown.

The bottom line is markets will rise, values will increase, and money will be made. Not every quarter or even every year, but the secular trend is up and, most likely, the cyclical trend is up too. There will be a time, although maybe not with the current administration and Congress, when hard decisions will be made and this country will be renewed. Of course, by the time that occurs, the markets will have discounted those events, leading to full or even cyclically excessive valuations. Don't wait for spring—invest in winter.

Wishing you all the best in 2013.

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

GW&K UPDATE *12/31/12*

TOTAL ASSETS UNDER MANAGEMENT	$17.1 Billion
TOTAL EMPLOYEES	96
TOTAL INVESTMENT PROFESSIONALS	31

NEW YEAR, NEW LOOK, NEW WEBSITE, NEW SPACE!

As we begin 2013, we are so pleased to have unveiled GW&K's new look over the past few months—most recently our new website. We have pushed the refresh button on how we present ourselves, but our company and our core values have not changed. We remain dedicated to meeting your needs with exceptional people, innovative thinking, a collaborative approach to investment management and meticulous service. We are committed to continuous improvement and always welcome your thoughts on how to do things better. We hope you will visit us soon in our newly renovated office space and on the web, **www.gwkinvest.com.**

BENJAMIN GANNETT RETIRES

One of the firm's founders, Benjamin Gannett, retires from GW&K. The firm and its success have been a primary focus of Ben's life and one of his proudest achievements. His commitment, care and work ethic, both internally and with clients, have been a foundation on which GW&K has been built. Ben has been a trusted colleague, advisor and friend. He will be greatly missed.

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

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

The municipal market was able to eke out modest gains in the fourth quarter even after tax-exempt yields broke sharply higher in December. The sell-off reversed a remarkable post-election rally that had pushed yields to fifty-year lows by the end of November. The anticipation of higher tax rates in 2013 supplied the catalyst for the rally while heavy flows into tax-exempt mutual funds provided the technical support. But when new issue volume picked up in early December and investors simultaneously stepped back from an over-bought market, the results were predictable: a sharp correction that saw tax-exempt rates retrace earlier gains. While the sell-off was enough to derail fourth quarter performance, municipal bonds still posted solid gains for the year, particularly at the long end of the market.

New issue volume for the year rebounded from the decade-low levels of 2011, but the nature of that issuance had important implications for market performance. A massive increase in refinancings pushed total issuance 30% above last year. But new money borrowing was actually down slightly, continuing a move toward austerity that we've seen since the market melt-down of a few years ago. Because refunding debt tends to be shorter than new money issuance, the long-end benefitted from a relative scarcity of supply. With investors simultaneously reaching for income further out the yield curve, long-term municipal bonds were able to post double-digit returns for the year.

Concerns over municipal credit quality were muted in 2012 as a slow-building recovery continued to stabilize fundamentals. States reported consistent, if unspectacular, growth in tax revenues and default levels once again declined on a year-over-year basis. Going forward, pension reform and a reduction in federal spending will be major focuses on the credit front. While most states have already implemented some form of pension relief, regulatory changes in the way liabilities are reported will result in funded ratios that appear worse than official figures, prompting many legislatures to consider further measures. Keep in mind, however, that the magnitude of pension pressures differs dramatically by state, based on funded status, flexibility to navigate state pension laws and political willingness to tackle the problem. Another issue for states is the inevitable drop in federal aid given the broader desire to rein in the U.S. budget deficit. The trickle-down effect of reduced federal spending means states must remain vigilant with regard to budget discipline.

> "With solid fundamental footings, cheap relative valuations and a wildly successful historical record of providing state and local governments stable, low-cost access to credit, investors should feel confident that municipals will remain an important fixture in any portfolio."

As we head into 2013, technicals should remain a meaningful tailwind to the market. Supply estimates point to only a small increase over last year with refundings still dominant and new money far below its ten-year historical average. Higher marginal rates on income and the health care surtax should support overall demand. Less favorable is the historically low level of rates, which provides little cushion should risk appetite return to the markets. And while the fiscal cliff legislation left untouched the municipal bond exemption, the issue remains on the table for the next round of negotiation over entitlement cuts versus new revenue sources. While it seems likely that the 28% cap proposal resurfaces, the good news is that year-end valuations against Treasury yields reflect almost no tax advantage to municipal bonds at all. If the proposal became law, any overreaction by investors who arbitrarily dump municipal bonds should be seen as an opportunity to take advantage of a dislocated market.

As always, the key to navigating the uncertainty that lies ahead is to have a strategy firmly in place. While we don't know the outcomes of future rate moves or coming tax reform or international volatility, we believe we do know how to take advantage of any and all events. With solid fundamental footings, cheap relative valuations and a successful historical record of providing state and local governments stable, low-cost access to credit, investors should feel confident that municipals will remain an important fixture in any portfolio. We stand prepared for any changes that hit the market, whether technical, fundamental or political and will respond appropriately to unfolding events.

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	Portfolio Manager

21 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

Investors in risk assets enjoyed excellent returns during 2012, as aggressive central bank interventions fostered an environment of modest growth, dampened volatility, and overwhelmingly positive technical support. Risk assets raced higher until early May when deep concerns about the health of the global economy drove a spike in volatility and Treasury yields to generational lows. As has been the case throughout the post-crisis era, volatility set the stage for further monetary accommodation. Investors who stayed the course were rewarded by the European Central Bank's pledge to stabilize short-term sovereign yields and the Federal Reserve's (Fed) third iteration of outright balance sheet expansion which helped propel valuations to post-crisis highs at the end of the third quarter. Even brief bouts of volatility around the Presidential election and the fiscal cliff debate were unable to prevent most risk markets from posting near or better than double-digit returns this year, as the Fed cemented its accommodative stance with its mid-December announcement that it would pursue additional Treasury purchases until the domestic labor market is more fully healed.

> "Even brief bouts of volatility around the Presidential election and the fiscal cliff debate were unable to prevent most risk markets from posting near or better than double-digit returns this year…."

Investment grade corporate bonds were the most immediate beneficiaries of the Fed's newest round of quantitative easing. Despite a steepening Treasury curve, high grade bonds returned 1.04% in the fourth quarter. This sector ended the year up 9.37% implying a remarkable 693 basis points of excess return—the second highest level on record after 2009. The Financial sector, up 14.64% for the year, outperformed all other sectors and quality segments as the reduced systemic risk and increased regulatory oversight transformed the perception of this sector's credit risk. A blistering December rally propelled the high yield sector to finish up 3.29% and 15.81% for the quarter and year, respectively.

Fresh off the heels of the Fed's announcement of its third round of quantitative easing, Agency mortgage-backed securities began the fourth quarter at their tightest levels of the year but were unable to hold those gains as concerns about consistency at the helm of the Federal Housing Finance Agency following the Presidential election weighed on premium coupon valuations. The Mortgage sector returned –0.20% and 2.59% for the quarter and year, respectively.

The Treasury market weakened late in the quarter, as fears of higher inflation from multiple injections of liquidity around the globe and hope for a deal averting the fiscal cliff conspired to steepen the Treasury curve. With the yield on the ten-year note and the long bond rising 12 and 13 basis points to 1.76% and 2.95%, respectively, the Treasury market returned –0.09% for the quarter, leaving the index up 1.99% for the year.

As we moved through the quarter, it became increasingly apparent that the world's central banks had again succeeded in minimizing the likelihood of a systemic catastrophe and had positioned the global economy for growth. By maintaining an environment of repressed interest rates and improved access to credit, the Fed continues to allow our domestic housing market to heal and unlock the potential of the consumer. While the polarization in Washington has done little to improve the economic climate, we are hopeful that a credible resolution around the fiscal cliff and a healthier consumer will drive gains in manufacturing and output.

In this context, we enter 2013 prepared for near-term interest rate volatility surrounding the fiscal cliff negotiations with a longer-term expectation for a steeper curve as the economic outlook improves. As such, we shortened our portfolios and enter the new year duration neutral relative to our benchmarks.

With current spreads roughly in line with their long-term averages, we remain constructive on corporate credit. Valuations remain attractive relative to the negative real yields seen across most of the Treasury curve and the tight spreads on other government credit. Our focus within high yield remains on higher quality issuers, as we expect BB and B rated companies to best weather the modest outlook for growth and for their default experience to remain benign. We remain broadly neutral on mortgage-backed securities, as we believe they offer attractive valuations relative to other high-quality credit assets and will continue to benefit from deep technical support stemming from $40 billion of Fed purchases per month.

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	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 EQUITY	A core strategy that invests in both small and medium sized companies that offer sustainable earnings growth
SMALL CAP EQUITY	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 halves for the stock market this past quarter. First we saw the market in a steady decline, driven by uncertainty over the election, the European debt crisis, sluggish growth in the Emerging Markets expected to drive global growth, the impact of Hurricane Sandy, and fear of the impending fiscal cliff. But from mid-November on, the Market turned up on the hope that the fiscal cliff would be avoided, better housing data, the successful leadership transition in China, less concern for Greece, and comments from the Fed that quantitative easing and low rates would remain for an extended period of time. So we ended the quarter pretty much where we began, with stocks flat to up modestly. For the full year, stocks performed admirably, with gains of about 16% by both large and small cap stocks. And since the lows of nearly four years ago, the market has increased comfortably by over 100%. Yet far from feeling it is time to take money off the table, we continue to believe stocks will provide solid returns from here.

The S&P 500 Index of large cap stocks declined by a modest 0.4% in the fourth quarter. Winning sectors such as Industrials and Financials were those that are beneficiaries of economic growth. There were also losers such as Technology and Telecommunications, where some of the largest cap names were particularly weak in the quarter. Small cap stocks as measured by the Russell 2000 Index gained 1.9% for the quarter. The economically sensitive sectors such as Industrials, Materials, Consumer Discretionary and Financials led the way.

With respect to the economy, news of improvement is quite broad-based. The jobs picture continues to improve, albeit slowly. Both unemployment and initial jobless claims are at their lowest levels in about four years. New and existing home sales have been improving for about two years and home prices are trending up. Consumer spending continues to trend upward, including the important new vehicle sales number. While Europe remains a drag on the global economy, emerging markets are still strong. Commodity prices have been rather subdued, suggesting growth can occur without threat of inflation. And longer term, the growth in U.S. manufacturing employment and forecasts for U.S. energy independence bode well for our economy.

"Continued accommodative monetary policy the world over is likely to keep rates very low and encourage the purchase of 'risk' assets such as equities. Importantly, another driver of demand for equities will be the successful resolution of the tax portion of the fiscal cliff, with capital gains and dividend tax rates clearly better than feared."

Corporations remain in good financial health. Profitability is solid and corporate balance sheets are in good shape. Cash balances are high, and those companies who do carry debt have been able to refinance at very favorable rates. Cash that has not been reinvested in growth has been returned to shareholders in the form of dividends and share repurchases.

The market has been climbing a wall of worry for the past four years. Despite the improving economy, investors continue to pull money out of equities. Historically this has been a good contrary indicator of stock market performance. Continued accommodative monetary policy the world over is likely to keep rates very low and encourage the purchase of "risk" assets such as equities. Importantly, another driver of demand for equities is the successful resolution of the tax portion of the fiscal cliff. Newly signed legislation left tax rates for capital gains and dividends essentially unchanged for all but the highest income tax bracket.

We believe the factors discussed above create a continued positive outlook for equities despite the fact that stocks have already had a tremendous move over the past four years. There will still be market uncertainty as Congress works to resolve the spending portion of the fiscal cliff and the debt ceiling. This could be quite intense for the market late in the quarter, similar to what we experienced in late December, as the fear of automatic spending cuts and technical default on our debts will once again loom large. Nonetheless, we feel a resolution will take place, perhaps again right down to the wire.

We also remain confident that our focus on investments in quality well-managed companies selling at reasonable valuation levels will continue to pay off over the long term.

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