GW&K INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW 2Q 2014

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

What should we worry about more, inflation or deflation? For those investors who still remember the runaway inflation of the 1970s, the answer is, and has been, inflation. This fear has discouraged the purchase of intermediate and long-term bonds. And yet, interest rates have been in a secular decline for over three decades. For those whose savings are in money markets, CDs or short-term Treasuries, this decline has cost them an increasing amount of income to the point that they have been earning nothing these last few years. They cry out, *Where is that inflation I have been expecting? I need my money to generate income.*

In the other camp, which includes the Federal Reserve, deflation is the bigger concern. The risk related to deflation is an issue I have talked about for years. In that environment, people postpone purchases, hoping for lower prices. And while nominal rates fall in this scenario, the real costs borne by debtors increase. The resulting

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INDEX PERFORMANCE *6/30/14*

	CURRENT QUARTER	YEAR TO DATE
Barclays 10-Year Municipal Bond Index	2.49%	5.69%
Barclays Aggregate Bond Index	2.04%	3.93%
Barclays High Yield Index	2.41%	5.46%
Dow Jones Industrial Average	2.83%	2.68%
S&P 500 Index	5.23%	7.14%
Russell 2000 Index	2.05%	3.19%
NASDAQ Composite	5.31%	6.18%

SECOND QUARTER 2014 MARKET OVERVIEW

ECONOMY

- As expected, the challenging winter weather across the US had a negative impact on the economy. GDP for the first quarter originally came in at –0.1% but was revised down to –2.9%.
- The economy started to rebound in the second quarter as evidenced by more encouraging job growth. New jobs added to the economy averaged 272,000 per month during the second quarter and the unemployment rate dropped from 6.7% at the end of March to 6.1%.
- New home sales and housing starts rebounded in May after decelerating in the first quarter. The ISM Manufacturing and non-Manufacturing reports also showed a steady rebound throughout the second quarter.
- Inflation indicators (CPI and PPI) moved up this quarter but not enough to push interest rates higher.

FED ACTION

- The federal funds target rate remains unchanged at 0–0.25%. In their June meeting, the FOMC noted that economic growth has improved following the weaker first quarter. While labor markets have improved, they noted the continued weakness in the housing markets.
- As expected, the Fed announced the continued tapering of their monthly bond-buying program. Starting in July, the Fed will purchase $35 billion of bonds per month ($15 billion of Mortgage-Backed Securities and $20 billion of Treasuries).
- If the economy progresses as they expect, the Fed further indicated that the final reduction to the bond buying program would occur in October.

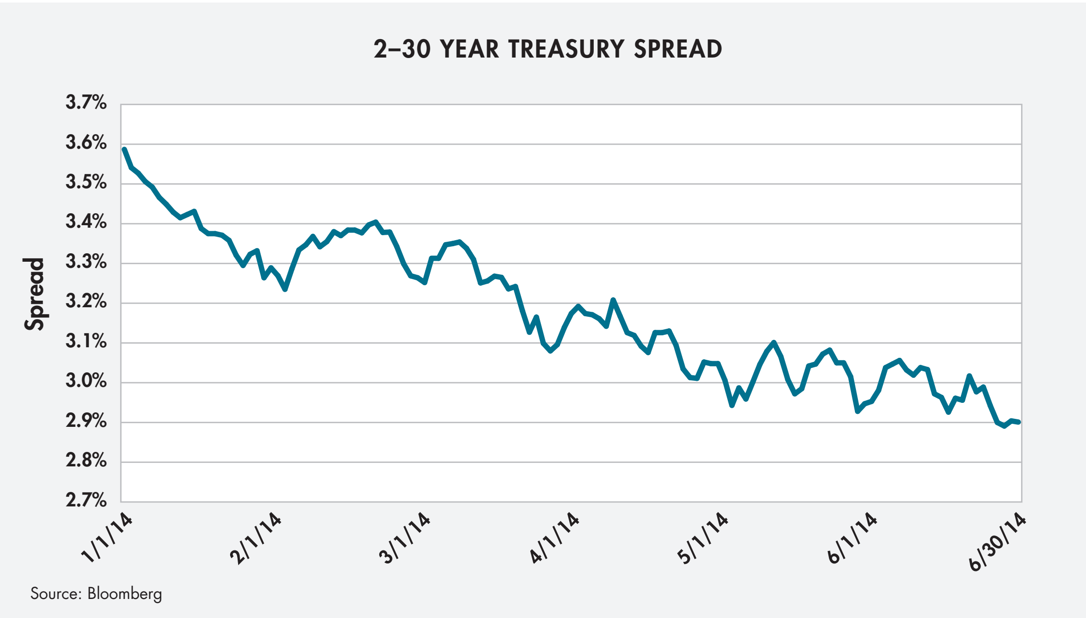
BOND MARKETS

- Despite improving US economic data, yields continued to decline in most areas of the bond markets. Investors' lack of conviction in the US recovery, Eurozone deflation concerns, and geopolitical unrest in Ukraine and Middle East were contributing factors. The 10-year and 30-year Treasury rates declined 19 bps and 20 bps, respectively.
- In the taxable bond market, continued demand for income, a benign default outlook, and favorable conditions for corporate fundamentals drove spreads toward 7-year lows across the credit spectrum. Both investment grade and high yield corporate bonds posted solid returns of over 2%.
- Municipal bond rates continued to decline following the lead of the Treasury market. Ten-year AAA municipal rates dropped 23 bps during the period to 2.26%.
- Municipal bonds outperformed Treasuries supported by strong technicals including limited supply and positive flows into mutual funds.

EQUITY MARKETS

- Economic growth recovered nicely from the first quarter's weather-induced slowdown, creating the backdrop for the market's advance and helping stocks finish the quarter with solid gains. For the third consecutive quarter larger cap stocks outperformed, extending their performance advantage over small caps.
- While all market sectors posted quarterly gains, we have seen a rotation in sector leadership as value and yield oriented sectors and industries had stronger gains this quarter. Energy was the best performing group due to attractive valuations and the quarter's rise in global oil prices.
- Flows into equity funds continued the positive trend that began just over a year ago. This is likely to continue as interest rates remain low and investors seek options for reasonable returns.
- Market volatility remains quite low, a signal of complacency in the markets.

ECONOMIC COMMENTARY, continued from page 1



The spread between short and long rates, which began the year at historically high levels, has flattened considerably over the first half of the year and a rise in short-term rates would push that spread even lower.

drop in demand reduces investment and sows the seeds of a deflationary spiral.

But as the economy continues to recover, the unemployment rate falls and the stock market rises, there is a renewed concern over inflation. As we all know, the Fed is pulling back its expansive monetary policy and getting closer to the day when they will begin to hike short-term interest rates. Pundits commenting on the Fed's timing often say, "interest rates will rise." How professionals can say interest rates will rise without an adjective is beyond me. Are they talking about *short-term*, *intermediate* or *long-term* rates? Do they know that these distinct segments of the curve are driven by many different variables? I am hoping for a modest rise in short-term interest rates. It will put more discretionary income into the hands of all those savers who have kept their money in short-term vehicles. The cost to the borrower, of course, will rise, but would still remain low enough to encourage investments. What is a modest increase? I would put it at somewhere between 1% and 2% on the short end.

A small hike in short-term rates would boost consumption, dissuade speculation and establish a healthier interest rate environment. It would not automatically push the yield on all maturities higher by 1–2%. Instead, the yield curve would continue to flatten. The spread between short and long rates, which began the year at historically high levels (see chart), has flattened considerably over the first half of the year and a rise in short-term rates would push that spread even lower. In simple language, intermediate and long-term interest rates will not rise equal to the rise in short-term interest rates, thus a flattening of the yield curve and a more normal environment.

The rise will only be modest because the deflation bug is real and the Fed cannot afford to kill a still anemic recovery. On the other hand, the Fed has to retreat from its present policies. I believe the US economy, because of the extensive levels of unemployed and unemployable, will grow very slowly and any large changes in borrowing costs would snuff out its momentum.

So why do stocks keep rising with such a slow domestic economy and how do I reconcile low interest rates with a growing stock market? Here is the *ah-ha* moment. Bonds are a function of the domestic economy. Rates need to be kept relatively low to grease the engine of our system. Stocks, however, reflect what businesses can do in a world economy where growth is alive and well. Bonds are a reflection of our domestic troubles while stocks are a reflection of the international opportunities.

It has always been US policy to encourage world growth in the hopes of bringing more people out of poverty and, in fact, that is being accomplished. We did it to expand markets for our goods; a reverse colonialism. We did not occupy and steal resources; we gave other countries the opportunity to develop and grow their respective economies. If we only had the domestic market to sell to, we would be in a difficult situation. But businesses know how to operate in world markets and as foreign GDPs continue to grow, more stock opportunities will take shape. The grease of low interest rates needs to be maintained for businesses to have comfort that the "chair will not be pulled from under them," i.e., the avoidance of a severe spike in rates anywhere along the curve.

As short-term interest rates rise modestly and the yield curve flattens, don't hide from investments. Because when fear of the Fed's end game abates and the world does not come to an end, a healthier and more sustainable business cycle might create a celebratory environment that will take the U.S. economy to greater heights.

Wouldn't it be great and totally, *totally* unexpected if rates stay relatively low and the stock market expands *after* the Fed stops their buying program?! You have not heard that prediction on Fox, CNBC or Bloomberg.

Harold G. Kotler, CFA
CEO, CIO

GW&K UPDATE

TOTAL ASSETS UNDER MANAGEMENT	$21 Billion
TOTAL EMPLOYEES	102
TOTAL INVESTMENT PROFESSIONALS	32

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

13 Municipal Investment Professionals	**17** Average Years Experience	**13** Average Years with Firm

> "The fundamentals in the municipal market remain on solid footing. While the recovery from the Great Recession has been uneven and frustratingly slow, states have defied the doomsday predictions of mass defaults and are in much better shape five years on."

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 their second consecutive quarter of impressive returns, driven by strength in the Treasury market and a drop in tax-exempt supply. Economic data during the period was actually decent, with stronger readings from the job market, the housing sector and the consumer. But geopolitical turmoil and concerns over Euro region deflation trumped those encouraging signs and drove down yields on Treasuries, particularly at the long end. Meanwhile, the Fed managed to walk a fine line that left the market more wary of near-term Fed tightening but also more reassured that eventual policy removal would be transparent, drawn-out and measured. So while short-term Treasury rates actually rose modestly during the quarter, long-term rates dropped meaningfully, flattening the curve in bull fashion.

Municipals outpaced the rally in Treasuries, which is unusual when broader rates decline. The reason was a strong technical environment and the promise of more to come. Early in the quarter, the market received a reminder of the value of the tax exemption when Uncle Sam came calling for the final payment on 2013's income tax hike. Right on cue, flows into municipal bond mutual funds began to accelerate from their more modest first quarter pace, peaking in May. In addition, despite an uptick in June, new issue volume was down 9% relative to 2Q 2013 and down 26% compared to Q2 2012. Finally, the market looked ahead to the summer months, where nearly $20 billion in net negative supply is expected for July and August. The feeling seemed to be: get your bonds now, because they're going to be even harder to find in the months ahead.

The fundamentals in the municipal market remain on solid footing. While the recovery from the Great Recession has been uneven and frustratingly slow, states have defied the doomsday predictions of mass defaults and are in much better shape five years on. California, whose difficulties a few years ago were famously compared to those in Greece, has been emblematic of the resilience exhibited by the states. Back in 2009, the state was facing a multi-year deficit that topped $40 billion and had resorted to delaying tax refunds and issuing IOUs to vendors to conserve cash. Today, the state is projecting budget surpluses after slashing spending, raising taxes and implementing a simple legislative majority to pass annual budgets, which should mitigate the political dysfunction that long plagued the state's financial planning. In late June, Moody's upgraded California's rating to Aa3, the first time the state has enjoyed a double-A rating since December of 2002.

And yet, California, like most states, still faces challenges. While tax receipts across the nation have surpassed pre-recession peaks, they have lately shown signs of slowing. To balance budgets, many states delayed borrowing for capital improvements, but those investments can't be put off for long. Pension costs also continue to be a concern, though less so in the Golden State than in some others. But while these are all important issues, they are also manageable. The fiscal discipline demonstrated by the states through the teeth of the credit crisis was not an accident. Nearly every state is either constitutionally or statutorily mandated to balance its budget. This forces solutions even when states face the difficult political hurdles of raising revenues or cutting expenses. Going forward, we expect the states to maintain the credit gains they have achieved over the last few years and to continue to provide the stability we have come to expect even in the worst of times.

We have positioned our portfolios to take advantage of an impending swing in market technicals. Outsized coupon and maturity redemptions, typical of the summer months, will add to the already considerable amount of cash sitting on the sidelines. This should create a surge in demand that will fight over a seasonal drop-off in new issue supply. The resulting underlying strength should provide a tailwind for municipal bonds over the next quarter. While this technical picture looks strong for municipals in the upcoming period, we are still aware of the potential for a rise in broader rates which would drag municipal bond yields higher.

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

9 Taxable Investment Professionals	**16** Average Years Experience	**10** Average Years with Firm

"Moving into the second half of 2014, market volatility is likely to stay low as the Fed maintains its zero interest rate policy, which it is expected to do through September of 2015."

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

Coming into the second quarter, investors worried that higher rates were on the horizon. After all, one of the worst winters in recent memory had just come to a close and the economy seemed poised for a sharp rebound. Instead, the Treasury market rallied hard in response to geopolitical events in Ukraine, concerns about weak global growth and the threat of deflation in Europe. And though the tone of US economic data improved during the quarter, inflation and wage growth nevertheless remained well below the Fed's goal. The central bank responded with a dovish view on rates, outlining a drawn out and shallow path for the federal funds rate.

The yield curve continued to flatten toward a five-year low, as the short end barely budged while the long end rallied to its lowest level in almost a year. A combination of geopolitical risk, pension fund buying and monetary easing in Europe made comparatively high yielding US debt more attractive. With the exception of the 2-year Treasury, which rose 4 basis points and closed the period near its year-to-date high, the entire curve shifted lower during the quarter. The 10-year and 30-year Treasuries moved in parallel fashion, 20 and 22 basis points lower, respectively, to 2.53% and 3.34%. The Treasury sector overall posted a total return of 1.4% during the quarter, lagging the Barclays Aggregate Index's total return of 2.0%.

Investment grade corporates posted a 2.7% return thanks to a benign default outlook, continued demand for yield and favorable conditions for corporate fundamentals. Within the investment grade sector, bonds rated BBB led the way, returning 3.2% for the quarter. Meanwhile, the high yield sector posted its 10th consecutive month of positive returns at 2.4%. Within the government-related sector, taxable municipals posted a strong 4.1% return during the period, a reflection of their long duration, and mortgage-backed securities returned 2.4%.

Moving into the second half of 2014, market volatility is likely to stay low as the Fed maintains its zero interest rate policy, which it is expected to do through September of 2015. As we approach the inevitable tightening cycle, rates at the front end of the curve are likely to rise, while the longer end should remain relatively anchored by low inflation expectations and a modest long-term growth outlook. Ultimately, we think that slow but positive growth, gently rising interest rates, and strong consumer and corporate balance sheets support a favorable view of risk assets, though there are a number of factors that could make the path a bumpy one.

We continue to prefer investment grade corporate bonds over Treasuries, given their defensive spread cushion and our expectation of continued strength in profitability and responsible financial policies among investment grade issuers.

Within the investment grade space, we have a strong preference for BBB credits, which offer an attractive pickup in yield relative to A-rated credits for acceptable levels of additional credit risk. And we continue to have overweight positions in the more cyclical corners of the market, which we expect to be the biggest beneficiaries of an economic recovery and where weak sentiment has made valuations attractive.

We are similarly inclined to buy high yield in eligible strategies, as a benign default outlook, strong corporate fundamentals and robust demand for yield support a favorable view of the space. We see room for spread compression in high yield relative to historical levels, and believe that an allocation to this sector also offers protection in the event of rising rates. We do recognize that there are downside risks in credit, given valuations inside of historical averages and less liquid markets following regulatory changes, but we continue to believe the sector offers value. Here too we find the most attractive valuations in the more cyclical sectors. We remain neutral on mortgages. Though we still believe yields are attractive relative to Treasuries, negative technical pressure following the removal of Fed support could lead to potential spread widening. Within mortgages, we continue to favor short duration, higher coupon assets that offer better carry and less spread duration.

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

10 Equity Investment Professionals	17 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

Stocks began the quarter with a brief two-week period of modest declines, yet by mid-April began a slow and steady climb that continued with few interruptions throughout the quarter. While this upward climb was more evident among larger cap stocks, which extended their performance advantage over small caps to three consecutive quarters, even small cap stocks were able to post modest gains by quarter's end. Economic growth recovered nicely from the first quarter's weather-induced slowdown, creating the backdrop for the market's advance. Importantly, interest rates remained tame, not moving meaningfully as many feared in this period of Fed tapering. This compelled more investors to seek out reasonable returns by investing in equities.

The S&P 500 Index posted another solid quarter with a gain of 5.2%. All sectors of the market participated, with Energy far outpacing the rest due to attractive valuations and the quarter's rise in global oil prices. At the other end of the spectrum, the Financials sector posted only modest gains as the money center banks lagged. The Consumer Discretionary sector also posted only modest gains, primarily due to the continued anemic spending on smaller ticket retail items such as restaurants and apparel. The Russell 2000 Index reported a modest gain of 2.0% in the quarter. While the sector laggards and leaders were generally the same, smaller cap names performed much worse than their larger cap siblings in nearly every major market sector.

In this environment, our performance was solid and ahead of the benchmarks this year for our Equity Dividend Plus Strategy. Our other equity strategies did not fare as well and trailed their respective benchmarks. Stock selection was the primary culprit. We also suffered from the headwind of underperformance of the less volatile stocks and industries that make up the majority of our portfolio holdings across our strategies.

Our outlook for the stock market remains generally positive as it has for the last several quarters. While not all economic signs are positive, the vast majority are improving and remain constructive. The jobs market continues to improve, with the unemployment rate still dropping, jobs creation growing, and unemployment claims dropping. Trends across broad sectors of the economy, including Manufacturing, Services and Consumer Confidence also remain constructive. Spending on big-ticket consumer items such as automobiles sits at levels not seen since before the Great Recession. Housing prices remain strong, home sales activity is improving, and household wealth continues to advance. And perhaps most important, even though we are in the midst of Fed tapering, the Fed remains committed to an accommodative monetary policy which should keep short-term rates quite low.

> "Our bias toward positive economic growth and a positive stock market remains intact. Yet this outlook does little to impact our primary investment philosophy of finding high quality companies with consistent and sustainable earnings growth as the best way to outperform over time."

While inflation has ticked up modestly, it is still at a level low enough to not concern the Fed.

Equity markets continue their bull market run, with most major indices hitting record highs. Flows into equities continued their positive trend that began just over a year ago. Yet despite positive flows, individual investors remain underweighted in equities compared to past levels. With rates being so low, limiting options for investors looking for reasonable returns, the tailwind of money flows moving into stocks is likely to continue. High corporate cash balances, as well as access to low borrowing rates, should also act as a continued tailwind for equities. Increasing dividend payments, share repurchases and accelerating acquisition activity all support positive stock market returns.

While we are believers in a positive economic growth scenario, we remain watchful of signs that might derail the economy or the stock market. Political and military disruptions around the globe can always play out in ways we don't expect. For example, the resulting rising oil and gasoline prices are having a negative impact on industry and consumers; although not yet at a level that should seriously hurt the economy. Growth in China, Europe and emerging economies remains subpar, which can impact our markets as well in this global economy.

Our bias toward positive economic growth and a positive stock market remains intact. Yet this outlook does little to impact our primary investment philosophy of finding high quality companies with consistent and sustainable earnings growth as the best way to outperform over time. Companies that meet these criteria give the best protection should markets decline, yet they also tend to participate when markets are doing well. We continue to seek out and find such ideas at reasonable valuation levels even as the stock market pushes equity prices to new highs.

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