Fourth Quarter 2012 Market Review

ECONOMIC (POLITICAL) OVERVIEW

BREAKING NEWS: You guessed it, politics, once again, was at the top of the economic leaderboard.

By a vote of 257-9 from the House and an 89-9 vote from the Senate, we politically dodged a low hurdle (fiscal cliff- basically went under it) only to face a high one (debt ceiling). Reason: The plan does not prevent a 2% increase in payroll tax, which will have a significant impact on consumer spending growth in the near term, nor does it address the federal debt ceiling (the next high hurdle). What it did accomplish was raising taxes on upper income households, postpone spending cuts for 2 months and provide a permanent fix to the Alternative Minimum Tax. Estimates are this accomplishment will run the government for an additional 8 days.

PRIMARY STRATEGY FOR 2013

Our primary investment strategy for 2013, as in 2012, continues to focus on safety and income at a reasonable price. In addition, we will focus on reducing duration and improving quality (possibly causing yield to lower). Although we don't anticipate higher rates in the immediate future, we have to prepare for its eventuality by continued laddering and duration reduction. Since each client has different risk tolerances, safety and reasonable price have different interpretations.

Current Situation:

Because of the constant stream of fiscal stimulus by the FED to kick start the economy, we have operated in a very low, artificially driven interest rate environment. Also, we have seen the relationship between bonds and stocks change, i.e., investors are gravitating to the equity markets instead of bonds for yield in a world where yield is a scarce commodity.

Further, with market uncertainty driven primarily by politics, we have seen extreme market volatility, a market more suitable for traders than investors.

For insurance companies where cash flow typically trumps total return, FED actions and a low interest rate environment have and will make investing a challenge.

Before we get into 2013, let's quickly review 2012. As in 2011, although we prefer Government bonds, corporate bonds were the cornerstone of our investment. Why? Let's discuss:

Government Bonds (GNMA, FNMA & FHLMC)

The very low interest rate environment made government bonds unattractive, especially the type we purchase, i.e., those with minimum extension risk should rates climb. In addition, the FED purchase of these bonds greatly

reduced inventories. We also saw this sector in our portfolio shrink as refinancing and FED purchases gradually took our bonds away. True Government bonds have no credit risk, but they do have interest rate risk. So, with a low interest rate environment, one has more downside than upside potential. Although, we may see a slight rise in rates, this sector should provide little opportunity in 2013.

Let's briefly mention non-agency mortgage product (or private label mortgage product). This sector may provide some buying opportunities in 2013, but I don't believe we have the risk tolerance for these type products (The only private label mortgage product we owned was a Chase product which you did not feel comfortable owning.)

Investment Grade Corporates

For 20 years, the largest sector in our portfolios has been Government mortgage obligation, either straight GNMA's with an explicit government guarantee or GSE's with an implicit government guarantee. Because of market conditions and where we saw the market going, we shifted our focus to corporates bonds. Reasons:

In a sustained low interest rate environment, although we would experience gains in our current holdings; new purchases would not fit our risk reward characteristics.

In a low interest rate environment, refinancing would reduce this sector. (Reduction in this sector was further compounded by the FED purchases of these products.)

Had we maintained our large percentage in mortgages, right now we would be sitting on a lot of cash in a low interest rate environment.

We began by researching AA & A rated bonds but found very little that fit our criteria. What we found we bought. Because of this, we determined that large pension funds and large insurance companies that rely on cash flow would be forced to buy either junk below BBB rated or BBB for those whose guidelines do not permit junk bonds to meet their immediate payment obligations. In addition, with only 4 AAA U.S. corporate bonds and very few AA & A rated bonds that are deleveraged and have descent yields, movement into these ratings seemed inevitable. Then, when our U.S. Treasury bonds were downgraded, movement into this rating accelerated. It is important to understand the criteria we use for these purchases. The number one criteria is can they service their payment obligations. Second, we diversify to the extent possible by region, sector and issuer.

Equities

Because of the shift to dividend paying equities over bonds by investors, we saw an opportunity to add 5% of our portfolio to equities. Because of extreme volatility, we halted filling this sector at 1.7% until we see some sense of direction.

What will be our strategy in 2013?

First of all, any strategy has to have a degree of flexibility when our markets are more driven by politics rather than economy.

As mentioned above, our primary investment strategy for 2013, as in 2012, continues to focus on safety and income at a reasonable price. In addition, we will focus on reducing duration and improving quality (possibly causing our yield to lower). We will do this by selling some of our longer BBB maturity bonds when possible and

buying shorter maturities or higher rated issues. Although we don't anticipate higher rates in the immediate future, we have to prepare for its eventuality by continued laddering and duration reduction. As of now, corporate bonds present the best opportunities in 2013. We feel very comfortable about managing the credit risk in our corporate positions. Our companies have strong balance sheets and through deleveraging maintain high cash balances on their books. We will continue to look for opportunities in the Government mortgage sector. We will add to our equity and municipal sectors when we see some semblance of direction.

Currently, the overall feel for the 2013 market points toward the equity sector. This may prove well for bond yields later on in the year and present an opportunity for reasonable yields in higher rated bonds. Why? Initially, money going into equities will come from money market accounts followed by bonds with tight spreads (AA followed by A and BBB, etc.). As bonds enter the market, spreads should widen giving us a buying opportunity. Patience continues to be the game.