Highlights

- Better than expected economic data boosted equity markets while U.S. treasuries declined. Higher yielding markets continued to outperform. Our portfolios benefited from exposure to higher yielding credit.
- Economists were forced to boost growth forecasts for the first quarter, although full year expectations remain modest. Though our base case calls for modest growth, we believe there could be a growth surprise in 2013.
- People are leaving the work force, likely a consequence of a coming demographic shift. U.S. demographics make it imperative we address debt and government expenditure issues.

Markets

		Returns (%)	
GIA*	Average Quality	1Q13	12 Months
Global High Yield Composite	(BB-)	2.85	12.18
Core Plus Composite	(A)	0.78	7.42
Core Composite	(A)	0.30	7.22
**Returns are net of fees*			
Benchmark Bonds			
Barclay's U.S. Aggregate Index	(AA+)	-0.12	3.77
Treasury	(AAA)	-0.19	3.14
Credit	(A)	-0.17	7.00
Mortgage	(AAA)	-0.05	1.98
Government/Credit	(AA)	-0.16	4.56
BoA Merrill U.S. Corps & Yankees	(A)	-0.08	7.27
BoA Merrill Corporate Master	(A-)	0.05	7.79
BoA Merrill High Yield	(B+)	2.87	13.05
JPM Emerging Markets EMBI+	(BB+)	-3.30	9.70
JPM CEMBI Broad	(BBB)	0.54	10.05
JPM GBI-EM Global Diversified	(BBB+)	-0.12	7.68
Citi Non-U.S. World Govt. Bonds	(AA)	-3.83	-2.16
Benchmark Equities			
S&P 500	NA	10.03	11.41
Nasdaq Composite	NA	8.21	5.69
Russell 2000	NA	12.03	14.60
MSCI EAFE	NA	4.38	7.78
Europe	NA	2.05	6.94
Japan	NA	10.73	6.31
MSCI Emerging Markets Equity	NA	-1.92	-0.63

Markets

U.S. equity markets "went on a tear" during the first quarter of 2013 delivering the best first quarter performance since 1998. The S&P 500 index returned over 10% and the Dow was up over 11.25%. Fixed income markets did not perform as well with U.S. treasuries declining 0.26%, corporate bonds "eking out" a 0.05% gain, high yield doing better at 2.87%, and emerging market corporate bonds up 0.54%. In other markets, Japanese equities continued their December move higher although the Yen depreciated, emerging market stocks had negative returns, and European equities were up about 2.0% in dollar terms. Overall, U.S. equities stood out aided by better than expected economic data and a healthy flow of funds.

Although flows into high yield funds moderated, the market continued to perform during the first quarter. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) was up 2.87% for the quarter following a 15.44% return for all of 2012. Spreads narrowed from 520 b.p. to 471 b.p., and the yield declined from 6.15% to 5.74% near record lows. After last year's record pace in the first quarter, high yield funds recorded about $900 million in inflows. The default rate remained low at 1.24%, well below the historical average of 4.0%. New issuance for the quarter was a record $118.8 billion eclipsing the prior record of $107 billion in 1Q 2012.

The Bank of America Merrill Lynch U.S. Corporate Index (C0A0) was affected by a back-up in interest rates, returning 0.05% and marginally outperforming the U.S. treasury index which returned (0.26)%. The 10-year U.S. treasury rate rose during the quarter to 1.85% from 1.76% even though the Fed continued to buy after announcing QE3 in December. Investment grade corporate spreads narrowed by 4 b.p. to 149 b.p., while the yield of the index rose from 2.76% to 2.79%. Issuance continued at a healthy clip reaching $294 billion slightly below the first quarter of 2012.

Emerging markets debt had a mixed quarter with dollar denominated sovereign debt returning (2.29)% and local markets debt returning (0.12)%. Meanwhile, corporate debt returned 0.54% reflective of a solid 2.08% performance by lower rated credits.

Portfolios

Our *Global High Yield Composite* consists of portfolios investing primarily in U.S. high yield, higher yielding investment grade credit, and emerging markets corporate bonds. The Composite underperformed the Bank of America Merrill High Yield Cash Pay Index by 2 basis point net of fees in the quarter, and was behind the index by 87 basis points over the last 12 months. During the first quarter, high yield outperformed emerging market bonds. Our composite retained exposure of 35% to emerging markets, contributing (7) b.p. to performance. Our high yield holdings outperformed the high yield index by 21 b.p., but were offset negative contributions of (12) b.p. from cash and (4) b.p. from investment grade holdings. The underperformance over the past twelve months was concentrated in the second quarter of 2012. During that quarter our emerging markets underperformed by over 100 b.p. as European banks sold assets to improve their capitalization. Our high yield holdings also underperformed as the economy stalled and the European crisis again took center stage. The Composite outperformed during the remaining 9 months, but was not able to fully offset the poor performance of the second quarter of 2012.

Our *Core Plus Composite* consists of portfolios that can hold up to 30% in securities rated below investment grade. The Composite outperformed the Barclays U.S. Aggregate Index, net of fees by 90 basis points for the quarter, and was ahead by 365 basis points over the last twelve months. Credit outperformed U.S. treasuries and mortgages and high

yield generated strong returns as investors continued to search for yield. The portfolios had exposure of about 20% to the plus sectors and an additional 10% to investment grade emerging markets corporate bonds. That combination was successful as treasuries declined for the quarter. Overall, the plus sectors contributed about 50 b.p. to excess returns with the remainder coming from successful security selection in investment grade credit. Over the last 12 months, investment grade and high yield credit outperformed. The Composite was overweight credit during all twelve months, leading to the outperformance.

Our *Core Composite* is an investment grade only composite managed against the Barclays Government/Credit Index. The Composite outperformed the benchmark, net of fees, by 46 basis points during the quarter, and was ahead by 266 basis points over the last twelve months. U.S. treasuries underperformed credit markets during the quarter, and the portfolio was overweight credit. Investment grade corporate spreads narrowed by 4 b.p. during the quarter, and the portfolio was roughly 65% credit and 35% government bonds. In addition, the portfolio's duration contribution was larger from corporate bonds than from government bonds benefiting from narrowing spreads. Over the last 12 months, the portfolio was overweight credit and enjoyed the benefit from the outperformance of that sector.

Economy

In our last Economic Outlook, we forecasted modest growth for the first quarter of 2013 even though many economists believed the fiscal cliff deal and eroding growth in Europe would cause deterioration in the U.S. Furthermore, indecision on the sequestration was expected to prolong inaction on the part of businesses. However, first quarter economic data surprised on the upside. Causes could include "pent-up" business investment demand after inaction in 2012, or perhaps low interest rates finally encouraged risk taking, or maybe the massive December dividend bonanza pushed investment into the first quarter. Regardless of the reason, economists were forced to raise their forecasts and U.S. stock markets delivered the best first quarter performance since 1998.

On average, economists surveyed by the WSJ Economic Survey raised their forecast for the first quarter to 2.2% in March from 1.7% in January. In addition, 73% of the respondents saw the risk to their 2013 growth forecast to be more to the upside. Two other significant survey results included an average response of only15% to the probability of a recession in the next 12 months and 53% of respondents judging monetary policy too easy and 0% judging it too tight. Combined with robust manufacturing data, solid corporate profits, and a loosening of credit conditions, these indicators confirm the U.S. economy is poised to deliver better performance over the remainder of 2013. While growth will likely surprise on the upside, we do not believe it will exceed 3% for the year, which most economists still deem to be below the economy's potential.

Holding back the economy over the next 6 months may be the impact of the sequester, the looming growth in healthcare costs, and the full impact of higher taxes. While manufacturers and home builders have led a resurgence in activity, retailers have not experienced similar growth. Furthermore, economic conditions in Europe have not improved and may be a further drag on the performance of a larger region that includes many emerging economies. Finally, China's newly installed leadership confronts many imbalances and a more restive populace as GDP transitions from export led to consumer led growth.

For the quarter, U.S. stock markets performed remarkably well suggesting investors became encouraged with the future for the economy and corporate financial performance. Around the world, Japan's equity market had a sharp move up (in Yen terms), but other equity markets were mixed. US treasury rates, which increased during the middle of the quarter,

declined in the later part of March to end only marginally higher for the quarter. Most major currencies depreciated against the US dollar. Global market performance would appear to confirm that investors favored U.S. opportunities over others, supporting the expectation of a better economy in 2013.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the economy growing 2.0% to 2.5% in 2Q and 3Q 2013. A confluence of favorable factors, including investor flows, boosted the U.S. economy in the first quarter especially after a disappointing fourth quarter of 2012. With businesses investing, home construction returning, and continuing monetary stimulus, the economy should deliver consecutive quarters of better growth. While favorable factors provide cause for optimism, difficulties in Europe along with the effects of fiscal tightening in the U.S. should keep the economy from reaching its potential. PROBABILITY 70%

2. A second scenario has the economy recovering to trend or perhaps above-trend growth of 3.0% to 3.5% over the next six months. An important contributor to fourth quarter growth (which was modest) was non-residential investment. For some time investors have expected corporations to deploy their sizable cash holdings. It is possible that after the fiscal cliff agreement, some confidence returned to corporate America, which may lead to additional investment. This could combine with other supportive factors like low energy prices and improved consumer leverage to push the economy into a stronger growth phase. PROBABILITY 20%

3. A third scenario has the economy declining to 0.0% to 1.0% growth due to larger than expected contraction from higher taxes, the delayed impact of sequestration, and another flare-up of the European debt crisis. In addition, some risk has appeared that emerging economies like China and Brazil underperform their growth expectations, bringing the U.S. economy to a lower rather than higher growth phase. PROBABILITY 10%

Market Outlook

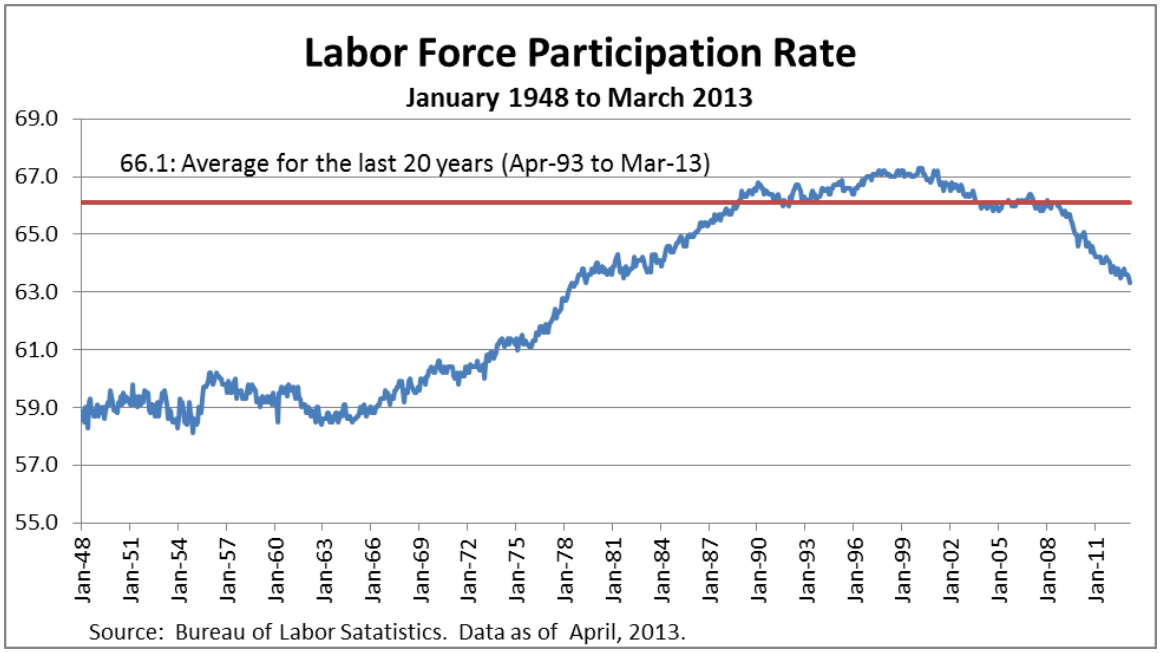
Positive surprises on economic growth and financial market performance are always welcome. While we remain encouraged that growth will remain reasonably good, we fear some U.S. markets outperformed expectations. U.S. equities returned over 10% for the quarter and may find it difficult to keep that pace over the next two quarters. Similarly, U.S. treasuries declined during the quarter, but rallied in the final week. One of these appears to be inconsistent. Our expectation is that over the next two quarters pressure will return for rates to rise, leading fixed income to deliver modest results. Credit markets performed acceptably during the first quarter, but remain attractively valued from a spread perspective. During the next six months we will continue to prefer credit over treasuries and mortgages and high yield credit over investment grade credit as we expect investors to continue to search for yield.

Commentary – About that Participation Rate

On April 5, 2013 the Bureau of Labor Statistics (BLS) reported that non-farm payrolls grew by 88,000 in March 2013, a lower than expected number. The unemployment rate actually declined from 7.7% to 7.6%, but less attention was given

to the fact that the survey of households showed a decline of 206,000 in people employed, and an even larger decline of 496,000 in the civilian labor force. In other words, fewer people were employed, but the unemployment rate went down because the labor force went down by more than the number of jobs lost. (The survey also showed a decline in the number of unemployed in March.)[1] Media outlets and economists did mention that the participation rate (the civilian labor force divided by the working age non-institutional population) went down and is now at the lowest level since 1979.

The graph below shows the labor force participation rate since 1948. As can be seen, the participation rate began to decline in 2008, which coincided with the financial crisis and the significant associated loss in employment. The graph also shows that participation rate began a steady ascent in about 1966 after nearly 20 years at less than 60%.



This rise was caused by the baby-boomers entering the working age population (age 16 and over) and a higher participation of women entering the work force. While the percentage of women in the work force has stayed at these higher levels, the baby boomers who created a population bulge in their age brackets over the last 60 years are now beginning to retire. Because of this and the U.S.'s demographic dynamics on productivity and retirement, we should expect the participation rate to continue a steady decline.

It took about 24 years for the participation rate to get near its eventual peak of slightly over 67% and over two thirds of the population made up the labor force over the last 20 years. According to census data, the next large population cohorts appear to be the baby boomers' children in the 15 to 30 year old brackets. This cohort is currently entering the labor force and should provide a modest participation offset to the withdrawing boomers. However, the data also shows the smallest population cohorts are currently between 30 and 45 years old, traversing their most productive work years.

Demographic analysis can help explain economic developments, often with the benefit of hindsight. It seems clear, that coming demographic shifts present significant challenges for the country and the economy. Firstly, the soon retiring

[1] Bureau of Labor Statistics News Release April 5, 2013

boomers, who helped expand the economy at a healthy pace during their more productive years, are expected to live 8 years more today than seniors in 1966. At the time the boomers commenced their working lives, the 65+ age cohort made up approximately 8.5% of the population and there were about 5.1 workers per retiree. In 2010 the 65+ cohort made up 13.0% of the population and there were only 3.0 workers per retiree. In addition, the Centers for Disease Control and Prevention (CDC) announced in February 2013 that the U.S. birth rate hit an all-time low in 2011. The demographic implications of this combination are daunting. The largest population cohort is retiring and the smallest cohort is not having babies.

Leaving aside important issues like population replacement, the financial burden on the young generations is mounting and the economic growth implications are worrisome. To start, the nation's debt could become unsustainable. In 1966 the nation's debt amounted to $320 billion, approximately $2,065 per person. Today the debt is $16.1 trillion or $52,000 per person. Inflation adjusted, debt per person would have risen to $15,000. Furthermore, when considered in terms of the number of working people, today's obligation reaches nearly $66,000 per person well over the country's annual median household income.[2] With debt forecast to climb and the working population likely to be flat or decline modestly, debt is likely to grow over $70,000 per working person over the next five years.

Another major concern relates to the growing share of government in GDP and the growing share of entitlements relative to aggregate government expenditures. With government expenditures nearing 25% of GDP and entitlements reaching 60% of expenditures, entitlement spending may soon exceed 15% of GDP or over $2.0 trillion. With fewer people working and no modifications to entitlement spending, payroll taxes could be forced higher, leading to sharp decline in workers' take-home pay.

We do not want to suggest doomsday is around the corner, but we do suggest that actions must be taken now to arrest the escalation in entitlement spending and contain the expansion of the nation's debt. With the current trajectories in government spending and demographic shifts, the nation's potential economic growth rate could decline making it more difficult to grow out of the problem. Nations like Japan and some European countries confront similar conundrums. While the best way to address the challenges is to reduce government expenditure, the country may be forced to look more seriously at other alternatives, like immigration. Whether we like it or not, our demographic profile may be the most forceful argument for a policy that incorporates a reasonable expansion of our working age population.

April 15, 2013

[2] Bureau of Labor Statistics data on Income, Employment and Inflation. U.S. Census data. U.S. Treasury.

GIPS requires GIPS Disclosure Statement (please see attached disclosure)
GIPS requires GIA fee schedule disclosure "GIA's fees are (i) .35% annually for standard USA fixed income, (ii) .50% annually for enhanced fixed income and (iii) .75% annually for specialized products"

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Management Fees, as well as account minimums and other important information are described in GIA's Form ADV - Part II. Since management fees are deducted quarterly, the compounding effect will be to increase the impact of such fees by an amount directly related to the account's performance. For example, an account with a 10% gross annual return and a 1% annualized management fee that is deducted quarterly will have a net annual return of about 8.9%.

*Important GIPS disclosures pertaining to composite performance may be found at the back of this letter.

Index Definitions

Barclays US Aggregate Index
The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Barclays US Treasury Index
This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Barclays US Government/Credit Index
The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Barclays US Credit Index
This index is the U.S. Credit component of the U.S. Government/Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Barclays US Mortgage Backed Securities Index
This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bank of America Merrill Lynch US Corporate & Yankees Index
The Bank of America Merrill Lynch US Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

Bank of America Merrill Lynch US Corporate Index
The Bank of America Merrill Lynch US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

Bank of America Merrill Lynch US High Yield Master Cash Pay Only Index
The US High Yield Master Cash Pay Only Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

JP Morgan Corporate Emerging Markets Bond Index (CEMBI)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified versions.

JP Morgan EMBI+ Index
The EMBI+ tracks total returns for U.S-dollar-denominated debt instruments of the emerging markets: Brady bonds, loans, Eurobonds. The EMBI+ currently covers 104 instruments across 15 countries.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

Citigroup Non-US World Government Bond Index
The Index is comprised of foreign government bonds with maturities over one year.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI EAFE- Europe Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe.

MSCI EAFE- Japan Index
The index is a capitalization weighted index that monitors the performance of stocks from Japan.

MSCI Emerging Markets Equity
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.