

Market Commentary

U.S. Fixed Income

H O L L A N D
C A P I T A L M A N A G E M E N T

As of March 31, 2008

Bond Market Review

The Lehman Aggregate Index, a measure of the overall domestic bond market, generated a total rate of return of 2.17% for the first quarter. The Lehman Government Corporate Intermediate Index generated a total rate of return of 3.00% for the first quarter. The positive performance was solely attributed to a decline in treasury yields due to rising expectations of a significant economic slowdown and the chaos in the financial markets as investors fled to the safety of U.S. Treasury securities, particularly T-Bills.

All the spread sectors significantly underperformed duration neutral treasuries as uncertainty and fear continued to dominate the capital markets. The financial market which funded the housing bubble has been threatened by a deepening of the housing recession as home prices continue to decline and delinquencies begin to spread from sub-prime to near-prime and prime mortgages. As solvency/liquidity concerns intensified in mid-March, the Federal Reserve stepped in with unconventional policy moves by providing a liquidity facility for primary dealers and financing for the acquisition of Bear Stearns by JPMorgan Chase. Shortly thereafter, Lehman Brothers successfully raised capital to shore up its balance sheet with additional firms announcing their intent to raise capital to offset sizeable asset write downs. As a sense of calm came over the market, spreads began to gap in during the latter half of March but not enough to generate positive excess returns for the corporate and asset-backed sectors.

We believe difficult times still lie ahead for the financial markets, particularly should the economy face a deeper recession than currently discounted. Consumers continue to face falling home prices, higher energy and food prices and a contracting labor market. Any major shock to the financial markets would undermine the economy.

Corporate spreads will remain at risk while the pace of economic growth continues to decelerate. The finance component of the Corporate Index continued to underperform the industrial and utility sectors of the corporate bond market during the 1st quarter (-0.53% versus 0.00% and 0.77%, respectively). However, we maintain that the market turmoil has created attractive investment opportunities among some of the larger, diversified finance credits and we continue to generally be overweighted in the sector. For example, we added Merrill Lynch notes and increased our exposure to Wells Fargo and Goldman Sachs during the quarter at spreads to U.S. Treasuries that would have seemed implausible only a year and a half ago. We expect to be equal weighted in the sector with a bias towards high quality issuers.

Mortgage-backed securities are expected to be supported by recent initiatives. The Office of Federal Housing Enterprise Oversight (OFHEO) reduced the capital surcharge from 30% to 20% on Fannie Mae and Freddie Mac and in February removed the caps on portfolio growth. Moreover, the Federal Housing Finance Board, the regulator for the Federal Home Loan Bank (FHLB) System, relaxed capital regulations

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for member banks and authorized MBS holdings up to 600% of regulatory capital.

During the quarter, prepayment proceeds were reinvested in conventional mortgage backed securities to maintain an equal weighting relative to the Aggregate. Added to the portfolio, at spreads as wide as 268 basis points, included a seasoned 5.50% 20 year mortgage; a new 5.0% 15 year mortgage; and a 5.50% REMIC with a stated final maturity of 13 years. We expect to be equal weighted in this sector during the next quarter.

Agency spreads remain attractive but are somewhat offset by the risk of more losses in agency mortgage portfolios if the slowdown deepens. During the quarter, several callable issues were called and the proceeds were reinvested in a mix of bullet and callable maturities with longer lock outs. To diversify the agency portfolio, Federal Farm Credit was added to the portfolio in January and February. We expect to remain overweighted.

Asset-backed securities are at risk of rising delinquency rates and rising default losses for credit cards and other consumer loans. Although we are overweighted in asset-backed securities, the primary holdings are in rate reduction utility bonds. This sector's weighting in the Aggregate is slightly less than 1%.

Commercial mortgage backed securities took a major hit in the first quarter as investors began to expect rising delinquency rates similar to the ones experienced in the residential mortgage market. So far there is little evidence of an uptick in delinquency rates and spreads began to gap in

late March. The sector does have risk as strip mall vacancy rates have recently picked up along with the slide in the economy. However, the CMB's in the portfolio are top tier tranches with weighted average loan to value of 55% to 57%. We expect to remain underweighted in commercial mortgage backed securities. This sector's weighting in the Aggregate is slightly more than 5%.

During a period of deepening aversion to risk, the portfolio's performance benefited from our emphasis on high quality liquid issues. The maturity structure of the treasury portfolio had a bias at the short end of the yield curve and benefited from the Fed slashing the fed funds rate 200 basis points during the period. Moreover, the corporate portfolio actually generated positive returns versus a negative 0.15% for the Corporate Index, again because of our conservative stance on high quality liquid issues.

And even in a period of rising volatility the mortgage portfolio did better than the Mortgage Index. Because of the housing recession and concerns of extension risk, the mortgage portfolio benefited from the strategy of being overweighted in 15 and 20 year collateral. Although the portfolio's holdings in commercial mortgage backed securities generated a negative return, they outperformed the CMBS Index, primarily due to the superior structure and older issues held in the portfolio. As for the asset-backed portfolio, there are no home equity loan securities in the portfolio, the sub sector that pulled the Asset Backed Index into negative territory. The only sector

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where the portfolio underperformed was in agencies as issues were being called left and right during the earlier part of the quarter. The portfolio duration averaged approximately 3.99 years, close to the target of 4.0 years.

Economic and Interest Rate Outlook

The economy barely grew in the final quarter of 2007, with real GDP advancing at a paltry annual rate of 0.6%. The 25.2% plunge in residential investment and the significant drop in inventories of \$18.3 billion overwhelmed the 2.3% gain in consumer spending and 6.0% rise in business investment. Moreover, without the benefit from gains in export activity, the economy contracted at a 0.4% annual pace, the first decline since the last recession in 2001. There is a good chance that the economy slipped into a recession during the first quarter. Economic data is not favorable and with rising foreclosures, declining home prices, falling equity prices, higher food and energy costs, tighter credit conditions and rising job layoffs, consumer spending is likely to retrench significantly during the next several months.

The gloomy economic conditions are not going to go away any time soon, at least not until housing begins to stabilize. However, there was a little ray of sunshine in the slight increase in February's existing home sales. The bad news is that home prices continue to fall. The median sale price declined 8.5% from February of last

year. And according to the Case-Shiller 20 metropolitan city house price index, there are no signs that home prices are stabilizing. In January the index dropped 10.7% on a year-over-year basis, surpassing December's decline of 9.0%. Any further acceleration in home price declines would increase the odds of a deeper and longer recession. However, there are some bright spots in the economy and one of them is the boom in exports driven by strong foreign demand and the weak dollar. The trade deficit excluding oil and aircraft dropped to \$26.8 billion, the smallest gap in nearly six years. Another bright area is inventories. With the steep drop in the fourth quarter, lean inventories should be a positive for the economy going forward. For now the sky is not falling. However, when the dust settles and the economy begins to expand, we suspect economic growth to be a slow grind as overextended consumers restructure their finances.

Good news for the economy can also be found in the policy moves made by the Federal Reserve. Since the start of the year the fed funds rate has been slashed by 200 basis points to 2.25%. However, these moves were not calming the chaotic credit markets where banks and investors were intensifying their aversion to risk. Counterparty risk and mistrust of collateral seized up the credit markets and liquidity became extremely scarce. To stabilize the markets and end the panic the Federal Reserve took on non-conventional actions that provided liquidity through various programs to depository institutions and more recently to primary dealers. In addition,

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the allowed collateral under these programs were expanded beyond just Treasury securities. Probably the most controversial action the Fed took is the financing of JPMorgan Chase's acquisition of Bear Stearns. The general view is that a bailout had to happen to avoid a bankruptcy filing that would have left the market asking "Who is next?" Some optimism has returned to Wall Street as several investment banking firms have successfully raised substantial amounts of capital to shore up their balance sheets.

For now inflation has taken a back seat although the market has not completely taken

its eye off the inflation data. And neither has the Fed given the two dissenting votes against the size of the March 18 rate cut of 75 basis points. Although commodity prices are going through the roof, commodities are a small share of overall production costs whereas labor costs are three-quarters of all costs. Consequently, with payrolls declining, upward pressure on wages sufficient to sustain a wage price spiral is highly unlikely. Finally, inflation tends to fall as demand slackens during a slowdown. The next Federal Reserve FOMC meeting is April 30 and the market is pricing in a 65% probability of a 25 basis point rate cut.

PORTFOLIO MANAGER



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