

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 December 31, 2009

Bond Market Review

The Barclays Capital Aggregate Index, a measure of the overall domestic bond market, generated a total rate of return of 0.20% for the fourth quarter. Spread sectors continued to experience spread compression but at a much slower pace compared to the first three quarters of the year. There still remains a lot of money looking for attractive investment opportunities. Moreover, in 2010, we suspect that the technicals of less supply (except for Treasuries) and high demand will keep spreads tight for quite some time. Although we do not believe the economy will dip back into a recession, if it did then spreads would likely gap out, particularly for corporates.

Portfolio Review

For the fourth quarter, the fixed income portfolio generated a return of -0.03%, gross of fees and -0.07%, net of fees compared to the Barclays Capital Aggregate Index of 0.20% for the period. The portfolio's underperformance was primarily attributed to the yield curve steepening to historical levels particularly during the latter part of the quarter. Market participants continue to worry about when the Fed is going to raise rates and unwind its balance sheet; two significant tasks that will not be easy to execute while the economy remains fragile. Through out much of the year, we have been going out further along the yield curve to capture the additional yield. However, it has been

painful as rates have risen from five year out to thirty year maturities. Fortunately, we have been underweighted in Treasuries. However, in the Government Related sector where we are overweighted, the steepening of the yield curve detracted from our absolute returns, particularly, for the Build American Bonds (BABS) purchased during the quarter. However, on a relative basis BABS spreads have tightened adding to performance on a relative basis. In addition, the longer dated callable agencies and step-ups gave us coupon income but detracted in price as rates began to move up during the later part of the quarter. Our corporate bond performance was extremely disappointing. Our high quality style, which served us well in the first quarter, worked to our detriment the rest of the year as we quickly lost ground in the second quarter and were never able to catch up. Our lack of exposure to mid-to-low BBB-rated securities was the primary culprit less so our underweight (albeit slight) in industrials and utilities and above index exposure to the finance sector. The fact that our corporate bond exposure was skewed to the intermediate and front end of the yield curve also hurt our performance throughout the period. Surprisingly, mortgages underperformed as longer dated collateral performed better than the intermediate collateral we hold in the portfolio due to our concern of extension risk. Holdings in Remics and ARMS were additive to performance. For the

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commercial mortgage backed portfolio, quality did very well but longer maturities benefited more from spread tightening. Our holdings are seasoned “AAA” structures that have shorter average lives. For the asset-backed portfolio, the utilities underperformed credit card and auto asset-backs. We are over weighted in the utility subsector and have no holdings in the autos. The portfolio’s duration averaged approximately 4.10 years which is about 94% of the duration of the Barclays Capital Aggregate Index.

For the year, the fixed income portfolio generated a return of 4.92%, gross of fees and 4.76%, net of fees compared to the Barclays Capital Aggregate Index of 5.93% for the period. The portfolio underperformed the Barclays Capital Aggregate Index principally as the portfolio was negatively impacted from the steepening of the yield curve as we went out in maturity to capture yield. In addition, the portfolio had too much quality in a period where market participants made a complete u-turn from risk aversion to risk taking as the government stepped in to stabilize the capital markets.

Economic and Interest Rate Outlook

Third quarter economic growth was revised down to an annual rate of 2.2% from the original estimate of 3.5%. Although the final number reported weaker growth, it represents a substantial improvement to the sharp declines in the previous four quarters. There is no doubt

that the collapse in economic activity was severe and has been labeled the steepest descent since the 1930’s. The good news is that the recession is over and the economy has turned the corner as consumer spending, inventories and export activity actually contributed to third quarter GDP growth. But keep in mind that temporary stimulus from the cash-for-clunkers and the tax credit for new home buyers played a hand in the recent recovery in economic activity. The debate is how strong will the recovery be and will it be sustainable. Initially, the economy will bounce back as the inventory cycle kicks in starting with the fourth quarter where growth is expected to come in at 4% plus. However, the headwinds from consumer deleveraging and high unemployment means consumers will remain cautious for some time. Consequently, the recovery process will take longer than previous recoveries as the economy has to deal with the lingering after-effects of the financial bust. Moreover, the labor markets will have to improve before growth can become sustainable. Hiring will turn positive by mid year but it is going to be a slow grind. Once job growth gains momentum, income growth will give consumers spending power which will sustain the recovery.

There will be intense pressure for interest rates to rise in 2010 as investors worry about “when” the Fed will begin to raise rates and unwind its balance sheet, particularly should the recovery be stronger than anticipated and inflationary concerns tick up. Moreover, the federal deficit is mushrooming and that too will have

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interest rate consequences as the current and projected deficits as a percentage of GDP increase over the next several years. All these concerns are real but will have to wait until the economy is clearly on solid footing before they can be seriously addressed. On the positive side, the Fed has communicated various exit strategies to

the market place and low inflation and excess capacity are providing policy makers some wiggle room. The economy is simply too fragile for tax increases and spending cuts. As illustrated below, yields on the ten and thirty year Treasury have already risen significantly.

Fixed Income Investment Team



Laura J. Janus, CFA
*Chief Investment Officer
& Portfolio Manager — Fixed Income*

Ms. Janus is a founding partner of Holland Capital and serves as the Chief Investment Officer for Fixed Income and as the Fixed Income Portfolio Manager. Ms. Janus holds primary responsibility for fixed income research and trading for the firm. She has more than 40 years experience managing taxable fixed income assets. Prior to forming the firm in 1991, Ms. Janus was a member of the investment department at Mutual Trust Life Insurance Company and was responsible for credit research and management of a \$200 million fixed income portfolio comprised of short term instruments, private placements, public bonds and common and preferred stock. Later she was elected Treasurer, which added responsibilities in the areas of banking relationships, cash flow management, five-year projection plans and budgets. Ms. Janus holds a B.S. in accounting from Western Illinois University. She currently serves on the WIU Advisory Board for the College of Business and Technology, the President's Advisory Board, and the WIU Foundation Board. In 2008, she was honored with the Outstanding Alumni Award from the WIU Department of Accountancy. Ms. Janus received the Chartered Financial Analyst designation and is a member of the CFA Society of Chicago and the CFA Institute.



Janet S. Henry, CFA
Senior Fixed Income Analyst

Ms. Henry is a Senior Fixed Income Analyst whose primary responsibilities at Holland Capital include the fundamental research and valuation analysis of fixed income. She has 31 years investment experience. Prior to joining Holland Capital in 2000, Ms. Henry was a founding partner with Heartland Trading Group, a Commodity Trading Advisor. Previously she was with Aon Corporation, where she was a Senior Portfolio Manager in the asset management division and researched and managed \$2 billion of domestic corporate bonds and structured mortgage-backed securities in fixed income portfolios. She earned an M.B.A. from the University of Chicago and a B.A. in history from DePauw University and is a member of The McDermond Center Board of Advisors. Ms. Henry received the Chartered Financial Analyst designation in 1989. Ms. Henry is a member of the CFA Society of Chicago, the CFA Institute and the University of Chicago Women's Business Group.

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