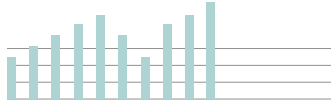


## Investment Snapshot

August 2011



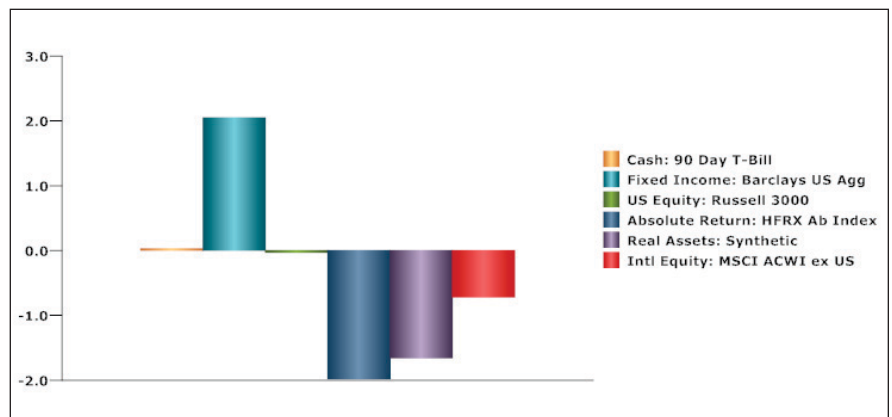
## “Soft Patch” or “Double Dip”?

The recent deceleration of the economy raises the question of whether the economy is entering a temporary soft patch or possibly another recession. Interest rates, valuations, economic growth, and employment are at historically low levels, which will present many opportunities and risks in the coming quarters. High levels of geopolitical concern and debt struggles among developed nations pose additional threats to the recovery.

We project subpar growth for some time as developed economies deleverage. However, in the long run, we believe that the global economy will recover, market forces will prevail, and patient investors will be rewarded.

## Performance Review: Second Quarter 2011

For the quarter, the Highland composite portfolio outperformed the benchmarks in every asset class except fixed income.



## Q2 Asset Class Composite Performance

Our defensive posture in US equities and our active exposure in international equities helped us beat the domestic and foreign equity benchmarks. Real assets were down slightly during the quarter due to the drop in oil prices, but we managed to outperform the overall index through gains in real estate. Our absolute return

managers were flat, which was well ahead of the index. In fixed income, we trailed the benchmark by a small margin because our duration was slightly shorter than the index to protect against interest rate risk.

(Please note that the discussion above is based on our firm-wide composite performance. Depending on your risk profile and other factors, your results may differ.)

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**Q2 Tactical Positioning Review**

We were tactically overweight US equity and underweight international equity, which boosted our returns as US beat international. Our slight underweight in bonds (based on our interest rate risk concerns) dragged on our performance when bonds advanced due to a general flight to safety.

**Tactical Positioning in 3rd Quarter**

Without any discernible trends in the market, we are moving our tactical weights fairly close to the strategic targets for the quarter. Our strategic targets provide broad diversification that should help cushion unexpected shocks. Many global economies have unsettled issues and we remain sensitive to the growing geopolitical risks; the current environment does not offer

enough reward to justify making large tactical allocations.

We maintain our short duration stance in fixed income. However, we reduced our underweight as inflation and interest rate risks have decreased in the near-term. The hedge exposure is also staying at an overweight to dampen some of the volatility we anticipate over the summer months and possibly beyond.

**Q3 Highland Tactical Positioning** as of August 1, 2011.

● underweight ● neutral ● overweight

⇒ Arrow indicates Q2 position

● **Fixed Income** underweight

<b>Inflation Hedge</b> neutral		⇒ ●	
<b>Core Bonds</b> neutral		●	↕
<b>US Active Bonds</b> neutral		●	↕
<b>International</b> neutral		⇒ ●	
<b>Floating Rate Bonds</b> neutral		⇒ ●	

● **Domestic Equities** neutral

<b>Large</b> overweight		⇒	●
<b>Mid</b> neutral		●	↕
<b>Small</b> neutral		⇒ ●	

● **Foreign Equities** neutral

<b>Developed</b> neutral		⇒ ●	
<b>Small/Mid</b> neutral	⇒	●	
<b>Emerging</b> neutral	⇒	●	
<b>Frontier</b> neutral	⇒	●	

● **Real Assets** neutral

<b>US Real Estate</b> neutral		●	↕
<b>International Real Estate</b> neutral		⇒ ●	
<b>Infrastructure</b> neutral		●	↕
<b>Energy</b> neutral		●	↕
<b>Precious Metals</b> neutral	⇒	●	
<b>Commodities</b> neutral		●	↕

● **Hedge** overweight

**Adjusting to Economic Shocks**

*Much of the recent economic slowdown may be attributed to one-time events. The tsunami in Japan disrupted supply chains in auto parts and electronics, the Arab Spring (the revolutions in the Middle East) contributed to higher oil prices, and rising food costs are the result of adverse weather affecting supply. If these issues begin to subside, then (in the absence of new macroeconomic shocks) global economies will be able to expand again.*

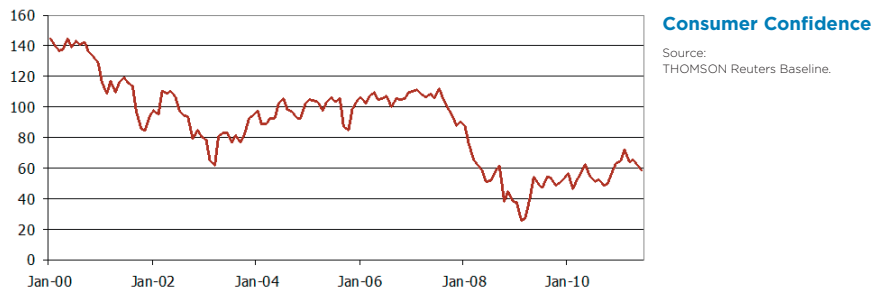


**Cyclical Sectors**

Cyclical sectors, such as auto sales, housing starts, manufacturing and business inventories are all low and unlikely to go much lower. Auto sales have averaged 14.6 million per year over the past 30 years and in June the Seasonally Adjusted Annualized Rate (SAAR) was 11.4 million.



Likewise, housing starts have averaged 1.4 million per year over same time period, but the number of starts in June was 629,000 units (SAAR). If the cyclical sectors were at higher levels, then any weakness would fuel further economic contraction. In contrast, the low levels may fuel economic expansion as any modest increases would boost investor confidence.



**The Bear's View: Weak Demand**

The lack of confidence among consumers and businesses has shown itself through weak aggregate demand (total demand of final goods/services in an economy). The Conference Board's Consumer Confidence Index is 58.5, which is up from the February '09 low of 25.3, but remains below the 30-year historical average of 93.6. Less-than-expected employment, consumer deleveraging, and stagnant wage growth account for much of the dour outlook.

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### **The Bull's View: Fiscal Strength**

*On the bullish side, consumer balance sheets have improved, thanks to better savings rates and lower debt service costs. Consumers have healthier credit ratings and housing affordability levels have improved across the country. Although banks remain cautious, they are less stringent about making loans. Company balance sheets are flush with cash and show strong profitability.*

*Global companies may benefit from the strength of emerging markets. China, Brazil, and India have actually raised interest rates to temper their rapid growth. Companies in developed nations participate in that growth, which in turn can buoy their operations and trigger expansion in their home countries.*

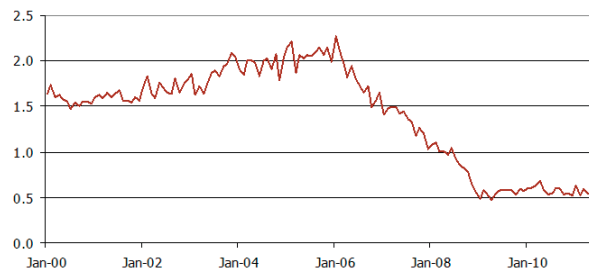


**S&P 500 Index**

Source: THOMSON Reuters Baseline.

### **Equity Valuations are Attractive**

Price-to-earnings ratios for the S&P 500 Index are trading at approximately 12.4 times forward earnings estimates compared to an average of 17.1 over the past fifteen years. Developed markets outside the US are trading at attractive valuations as well. Emerging economies are mixed with some more expensive than others but in general are not as attractive on a valuation basis.

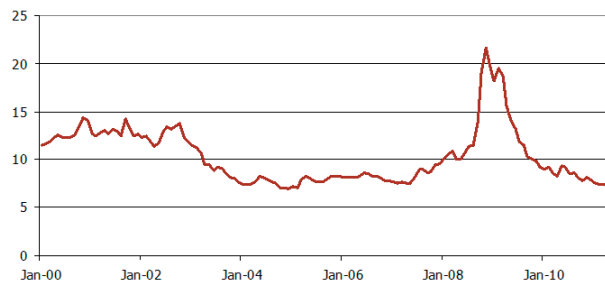


**Case-Shiller Home Prices**

Source: THOMSON Reuters Baseline.

### **Real Estate has Potential**

The continued weakness of the market offers some attractive opportunities in commercial and residential real estate. On the commercial side, apartments are most compelling, but are also more expensive than other property types. On the residential front, the combination of low asset values and historically low rates are a great boon.



**ML High Yield Index**

Source: THOMSON Reuters Baseline.

### **Fixed Income needs Flexibility**

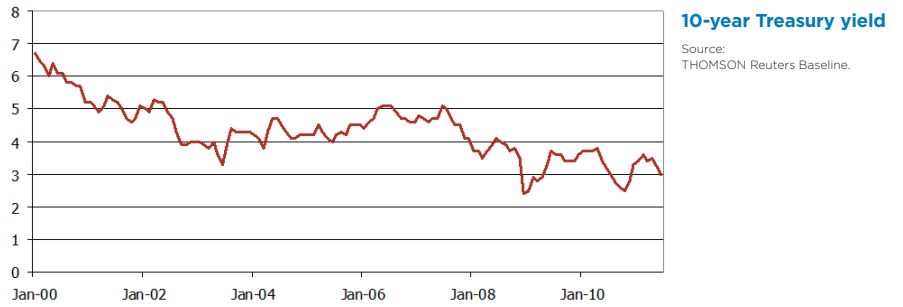
In the current environment, bonds do have risk (e.g. interest rates, Eurozone debt crisis), but also present opportunities for managers who are skilled enough to find them and nimble enough to capitalize. We prefer active managers with fairly broad mandates so they have the freedom to find opportunities.

For now, we still like floating rate bank loans (their yields increase when interest rates increase) as a way of protecting against some of the interest rate risk. Also, emerging markets bonds are attractive near-term since many of their central banks have raised rates to slow inflation. At the same time, the currency exposure provides some diversification against a possibly weakening dollar. For the longer term, we'll exercise caution in emerging markets bonds as they are currently trading well below their historical spread over treasuries.

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**Risks**

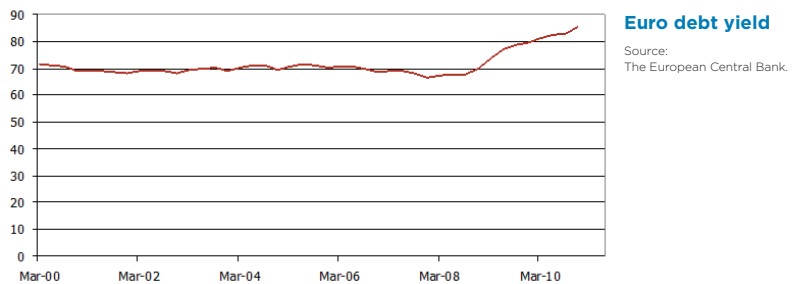
*While there are many reasons for hope, the lingering issues stemming from the financial crisis prevail. Interest rates, Domestic and international debt will all impact future growth.*



**Interest Rates**

We're concerned about interest rate risk, but the timing is unclear. The Fed will probably keep rates low for a while to avoid exacerbating our economic deceleration.

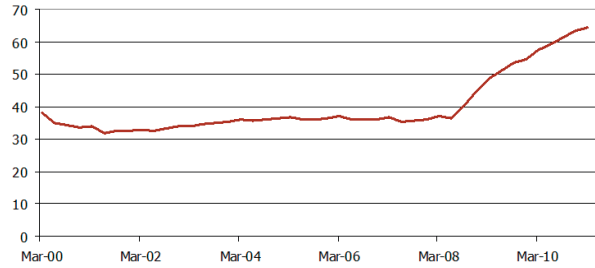
Under "normal" circumstances, we might expect the Fed to move interest rates about 2% higher than core inflation, which was 1.6% in June. Historically, the 10-year Treasury yield averages 2.8% above core inflation. So, in "normal" conditions, we would expect the 10-year Treasury yield to increase from its current 3% (in June) to somewhere around 4% to 4.5%. That's an increase of about 30% to 40%. Such a large increase in yields could translate to almost a 10% loss. In our view, current yields are still too low to compensate for the risk that rates increase. Even though the chance of a rate increase in the near term is low, we're staying on the short end of the yield curve to avoid unnecessary risk.



**European Sovereign Debt**

Europe continues to postpone resolving the sovereign debt issues with countries like Greece and Portugal. Some fear that the debt crises will undermine other economically fragile members of the Eurozone like Italy and Spain. We believe that stronger countries such as Germany benefit from the weaker countries in the Eurozone because it moderates the strength of the Euro and helps with their exports. Also, dissolution of the EU could create financially catastrophic consequences, depending on the circumstances and the process for dissolution. So, it seems that all parties have something vested in maintaining the EU, but the longer they wait to address their issues, the greater the problems become. We expect the debt issues to be a recurring theme and will continue to monitor them.

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**US Tax Revenue as % of Government Spending**

Source:  
THOMSON Reuters Baseline.

### Debt Ceiling

With the passage of the debt ceiling deal, the U.S. has avoided a default and won't face another debt ceiling vote until 2013. Now, the focus will turn to whether the U.S. can avoid having its debt downgraded since the deal was not as strong as rating agencies said it needed to be. On a positive note, Moody's just reaffirmed that the U.S. will retain its stellar AAA credit rating. The other concerns are how much business and consumer confidence has been lost amidst the political wrangling of the past several weeks and the implications of spending cuts on an already weak economy. While the cuts won't happen for a while, the deal creates more uncertainty because it didn't specify details. Rather, it pushed the specifics to a committee which means the economy will continue to pay an "uncertainty" tax until there's more clarity.

### Disclosure:

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