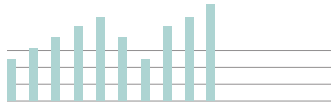


Investment Snapshot

January 2012

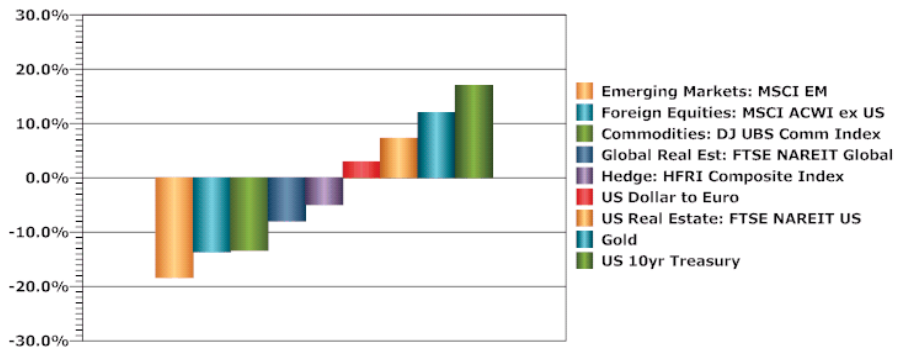


2012 Outlook

As we begin 2012, investors have the opportunity to position their portfolios for an eventual reversion to the mean. The volatility, confusion, and state of constant crisis that defined 2011 have set the stage for a brighter future for growth assets as they offer more value today. Safe havens that did well last year amidst the uncertainty will be challenged if the crisis mentality lessens. We will explain why many investors will likely remain risk averse this year and why there is reason to be optimistic. Uncertainty remains high and we still believe it's essential to be prepared for the downside as we are not out of the woods by any means, but it's just as important to prepare for the upside as achieving your future goals may depend on it. We believe our portfolios are well positioned to balance these competing forces and are poised to benefit when an eventual reversion to the mean occurs.

2011 Asset-Class Performance (in percentage change)

Source: Thomson Reuters Baseline



2011 Recap

From a valuation perspective, stocks ended the year cheaper than they started and bonds finished more expensive. Safe havens like gold, the US dollar, and US Treasuries all did well while riskier assets suffered. US equities managed a small positive gain with the S&P 500 index + 2.1%. International developed market indexes were -11.7% on sovereign debt worries and emerging market indexes fared worst of all with a

-18.2% return as investors sold off riskier assets. Most hedge funds posted negative single digit returns as they were whipsawed by the often directionless volatility. Natural resources suffered as a result of emerging market central bank tightening and general risk aversion with the Dow Jones Commodity index - 13.4%. Commercial real estate was mixed, with US REITs positive but international REITs negative.

“The unemployment rate should slowly decline due to increased business investment, pent up demand from consumers who can afford to spend more and more baby boomers retiring.”

Primary 2012 Themes

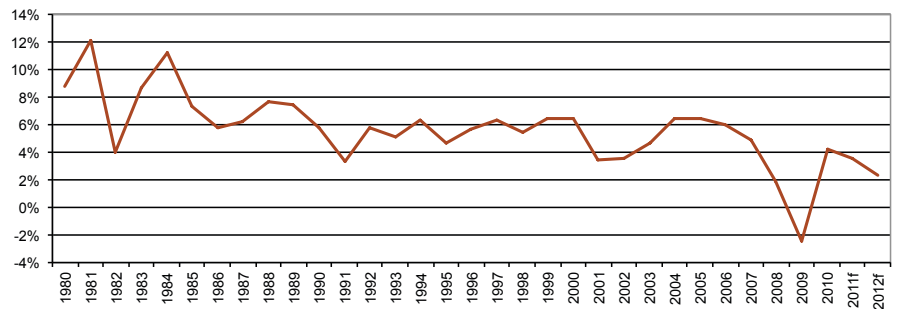
Economic Expansion Should be More Durable than Expected

Companies will face pressure to put more of their cash to work as they already have excess “rainy day” funds and top line growth will be more important as productivity gains will have less influence on earnings. The unemployment rate should slowly decline due to increased business investment, pent up demand from consumers who can afford to spend more, and more baby boomers retiring. The housing sector should finally start adding to US GDP. Some strategies that may benefit investors in this environment are:

- Focus on US companies that are increasing their dividends and pick up bargains in growth stocks that are highly undervalued due to economic fears.
- It’s a great time to buy a house or be a landlord, and less appealing to be a renter.

US GDP YOY Growth %

Source: Thomson Reuters Baseline



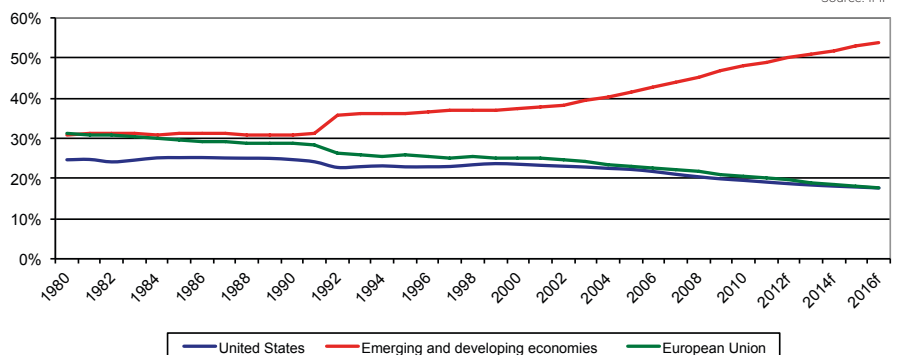
Emerging Markets Will Continue to Drive Global Growth

The industrialization of emerging economies is creating millions of new consumers every month and the most important governments (China) have the capacity to do whatever is needed to keep growth high. Over the past two years, most of the emerging central banks have been tightening to curb inflation and now they have started to ease as inflation is moderating. This should provide a catalyst for growth. In this environment investors might be drawn to:

- Multinational companies that sell to these markets.
- Local emerging market companies that have more direct exposure and a better understanding of these emerging consumers.
- Natural resources which should benefit from increased demand.

Percent of World GDP

Source: IMF



Crisis Fatigue & More Certainty Should Lead to Less Fear

Individuals and companies will continue to be risk-averse but they be less paralyzed by fear and should start engaging more meaningfully in the economy as the risks are better understood. There are still many uncertainties globally, but we know more about the European risks than we did in the 3rd quarter of 2011. And, once you understand the risks better, you can make a plan to deal with them - which is what companies, individuals, and governments have been doing. Strategies that may benefit investors in this environment are:

- Reducing exposure to investments that do well in the midst of crisis, such as the US Dollar and longer maturity high quality bonds.
- Increasing exposure to growth assets.

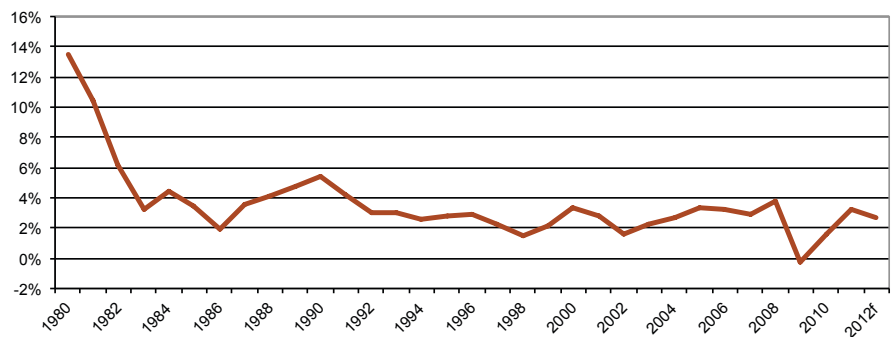
Money Printing Will Boost Inflation Concerns, but Inflation Should Be Modest In the Short Term

If a consensus forms that the economic recovery is sustainable, concerns about inflation will increase due to accommodative fiscal and monetary policies. The fear of inflation may cause investors to take on more risk:

- High quality dividend paying stocks should benefit from investors reaching for yield.
- Natural resources may see inflows if investors fear inflation.
- Longer maturity bonds may suffer.
- Lower credit quality bonds that pay higher yields may do well.

US Consumer Price Index (CPI)

Source: Thomson Reuters Baseline



Political Gridlock and Geopolitical Risk Will Subdue Growth & Cause Volatility

There isn't much incentive in the US to make major changes until after the election. Uncertainty about tax rates, government contracts, and policies may cause many to stay on the sidelines. Europe will likely continue to take modest and reactive measures towards a resolution, causing much fear along the way. Iran, Iraq, North Korea, Pakistan, Egypt, Venezuela, and many other turbulent areas are wild cards.

- Hedge funds offer a good balance of downside protection and return generation.
- Underweight Europe - but take advantage of cheap valuations in quality companies there.
- Maintain exposure to defensive stocks.
- High quality bonds should do relatively well if things get ugly, so maintain reasonable exposure despite low return expectations. Municipal bonds may see greater demand if taxes increase.

These themes could emerge or retract depending on a host of factors as we live in a very dynamic and fast changing time. In the pages that follow, we will expand on some of our themes, outlining what may go right and what could go wrong in the year ahead.

“Themes could emerge or retract depending on a host of factors as we live in a very dynamic and fast changing time.”

“Shareholders will pressure companies that aren’t investing their capital to return it to them via dividends or share buybacks.”

“Housing prices have declined by about one third since the peak and interest rates are at historical lows. This combination makes home ownership more affordable than ever...”

Reasons for Optimism

Declining Earnings Growth will put the Focus on the Top Line and Should Spur More Investment

Companies are going into 2012 with strong balance sheets and record earnings. We expect earnings growth to slow into the single digits this year, but each dollar of earnings may pack more punch than before. Why? The cash pile is large enough to cover a deep crisis and it detracts from return. Further, companies have already squeezed nearly all of the earnings growth they can from restructuring and technology improvements, making revenue growth a top priority. Revenue growth is achieved by hiring, expanding capacity, investing in new projects, spending on marketing/sales, and making mergers and acquisitions. Shareholders will pressure companies that aren’t investing their capital to return it to them via dividends or share buybacks. All of these uses of cash have a much stronger multiplier effect than what we have seen the past three years where companies were primarily concerned with “strengthening” the balance sheet.

Valuations Matter in the Long Term, and Stocks are Cheap Today

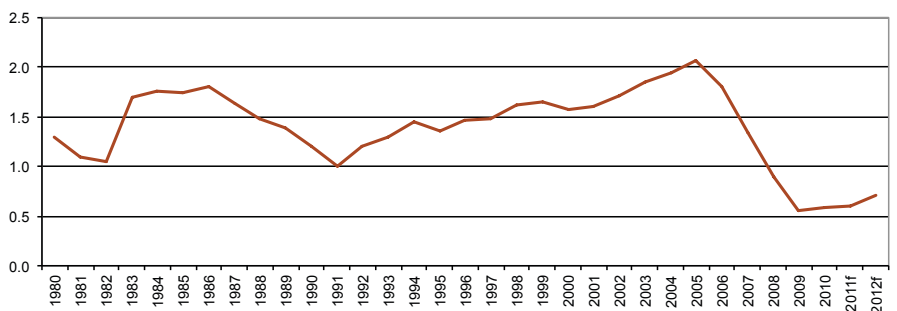
Empirical evidence shows that price/earnings ratios do not have much effect on one year returns but there is a really strong relationship to longer term returns. The data indicates that if you buy into the stock market when the P/E ratio is low, you have a much greater likelihood of higher long term returns than if you buy when the P/E ratio is high. Currently, the S&P 500 forward P/E ratio is 11.8, which would imply that there is good potential for upside over the next 10 years based on valuation alone. International developed and emerging markets P/E ratios are even lower. As a reference, the historical P/E for the S&P 500 is around 15 and the range is from 5 to 30. The forward P/E in March of 2000 was over 25, which is why the low returns this past decade aren’t surprising.

Housing Should Start Helping the Economy Again

Housing is normally a significant contributor to GDP but it has been a detractor for the past five years. The annual demographic demand for homes is slightly more than 1.2 million per year. We have been producing less than 600,000 new homes each year for the past three years. The excess inventory of bank-owned properties and unsold homes is falling, reducing the supply further. Housing prices have declined by about one third since the peak and interest rates are at historical lows. This combination makes home ownership more affordable than ever and cheaper than renting. All of these factors should give homebuilders ample incentive to build more homes. When more homes are built, there is a strong multiplier effect as more appliances, furniture, landscapers, real estate agents, bankers, architects, construction workers, and raw commodities are needed.

Housing Starts per year (in millions)

Source: Thomson Reuters Baseline



“Just when we thought that the various branches of the US government couldn’t be any more dysfunctional, they proved they could be during the US debt downgrade.”

Continued Industrialization / Build Out of Emerging Markets & the Emerging Consumer

Many of the emerging economies are expected to slow this year, but in the aggregate grow much faster than developed economies. One example of this growth is the Chinese government expects to see 7 million new affordable homes built in 2012 – and we aren’t even building one-tenth of that here! The industrialization of emerging economies is a major force that is helping soften the fallout from the debt overhang that burdens most of the developed world. While these economies are still dependent on government investment and exports to the developed world, the resulting growth of the emerging middle class consumer is decreasing that dependence.

What Could Go Wrong

Deleveraging

Deleveraging means paying down your loans and spending less. Governments have a long way to go while banks and individuals have made better progress. The primary risk this poses is that it is hard to grow when you’re cutting expenses; meaning economies are highly susceptible to unexpected economic shocks. Europe is in the midst of implementing austerity measures and this has likely pushed the region into recession. The US is in better shape economically, but austerity measures at the Federal level haven’t really started yet. We believe it will take many more years to get back to equilibrium and our baseline expectation is economic growth and investment returns will be less than the historical averages we have grown accustomed to.

Politics Influences Returns More than Usual

Just when we thought that the various branches of the US government couldn’t be any more dysfunctional, they proved they could be during the US debt downgrade. And then, we witnessed the serious weaknesses of the EU with its lack of fiscal unity. Since sovereign debt issues can sabotage the banking system and austerity measures can push economies into recession, political decisions are more impactful to investors than in the past. 2012 brings a presidential election that will bring many decisions to the voters and it will likely be a tight race so we don’t expect clarity until November.

Europe

We believe the Eurozone will experience a mild recession but the impact to the US should be modest. European consumer balance sheets seem relatively healthy and the region has not experienced cyclical excesses that normally accompany a recession. In other words, there’s simply less of a cliff to fall off of. Further, the ECB’s liquidity measures are helping the banks avoid a crisis and it buys policy makers some time. Our exports to Europe only represent approximately 3% of US GDP so a mild recession shouldn’t have enough impact to send us into a recession. However, there are plenty of reasons to lose sleep over the situation. The European banking system is fragile and policy errors could easily cause a liquidity and solvency crisis that could result in a depression there and severe recession here. Further, policy makers in Europe appear content to wait until the last possible moment to deal with a crisis, seemingly playing a dangerous game of poker with each another. If this continues, there’s increasing risk that the situation gets out of hand. Since Europe has the financial capacity to withstand the situation and the ECB is giving Europe more time to work it out, we think a major disaster will be avoided. However, we will continue to monitor this closely and remain underweight in the region.

“We worry about China because its growth engine is essential because it drives more than 25% of global GDP growth.”

Geopolitical Wild Cards

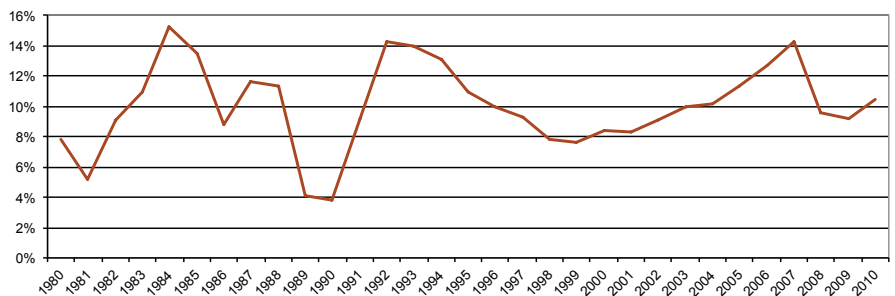
The Middle East has unresolved tensions, continuing protests, and little regional cooperation. At the same time, the United Nations and the US have less influence in the region. Iraq’s stability is now in question and tensions are rising with Iran as it moves its nuclear program underground. The transition of power in North Korea is concerning and there are scenarios that could put America and China in a military conflict. Pakistan faces political instability which will be further complicated once US troops start to leave Afghanistan. Populism has spread to more countries and while this can be positive, it creates uncertain outcomes. These risks all need to be monitored and will no doubt add to volatility. As a practical matter, we are currently underweight frontier markets that have more exposure to these issues.

China

China’s economic growth has been deteriorating since 2009, when the Chinese central bank began tightening. Within China, there has also been a surge of local government debt and much real estate speculation. They are undergoing a fairly major political transition and there are risks of foreign policy surprises. Tensions between the US and China are already high and could be exacerbated by a higher US security presence in the region. The Eurozone represents a small but meaningful percentage of China’s exports so if Europe has more than a mild recession, it could slow growth even further. We worry about China because its growth engine is essential because it drives more than 25% of global GDP growth. Fortunately, China has plenty of fiscal and monetary bullets to keep its growth very strong so we don’t think a hard landing is probable.

China GDP growth (as a percentage)

Source: Thomson Reuters Baseline



World Economy is Fragile

Perhaps the “butterfly effect” or the concept that small events can have large, widespread consequences is a good metaphor for the situation we find ourselves in today. The world is highly interconnected and the interaction of the various economies can ripple through the global economy quickly. If Europe’s recession is deeper than expected due to a policy blunder, it would certainly impact emerging economies like China that depend on exports. China would then require less natural resources and this would pressure countries like Brazil that are highly dependent on commodity prices. As Brazil and other emerging economies slow, there are fewer emerging consumers for US companies to sell to, causing a downturn here. While most emerging economies have the ability to stimulate growth, developed economies have fired most of their bullets. With less policy response available worldwide due to weak developed economies, a mild recession could turn into a severe downturn. We think the probability is low of a scenario unfolding like this, but it keeps us from being as aggressive as we would like to be given low equity valuations.

Summary

The confluence of events that led us to where things stand today makes this a great time to be a long-term investor but a very challenging time to be an income-oriented investor. We don't know if a reversion to the mean will begin in 2012 but we are confident that movement towards it should commence over the coming years. Studies in behavioral finance indicate that investors are often blinded by the recent past and make decisions assuming what happened in the last few months or years will continue into the future. This is likely why data shows investors have been pulling money from growth assets while adding to bonds and cash. We look at the empirical evidence to make our investment decisions and this suggests doing the opposite. As we enter 2012, we will overweight growth assets while maintaining adequate exposure to low risk assets to help defend against the many risks we outlined in this outlook.

Disclosure:

The information and opinions expressed herein may not be suitable for all investors and should not be construed as specific investment, tax, or legal advice or as an offer or recommendation to purchase or sell securities of any kind. Highland's opinions and judgments are based on historical data and current market analysis and are subject to change without notice. Investing in securities may involve risk, including total loss of principal, and as such investors should consult with their investment, tax and legal advisors before pursuing any investment strategy. All analysis and performance data, although provided by sources believed to be reliable is intended for illustrative purposes only and is unaudited; Highland does not warrant its completeness or accuracy. Past performance is not a guarantee of future results.