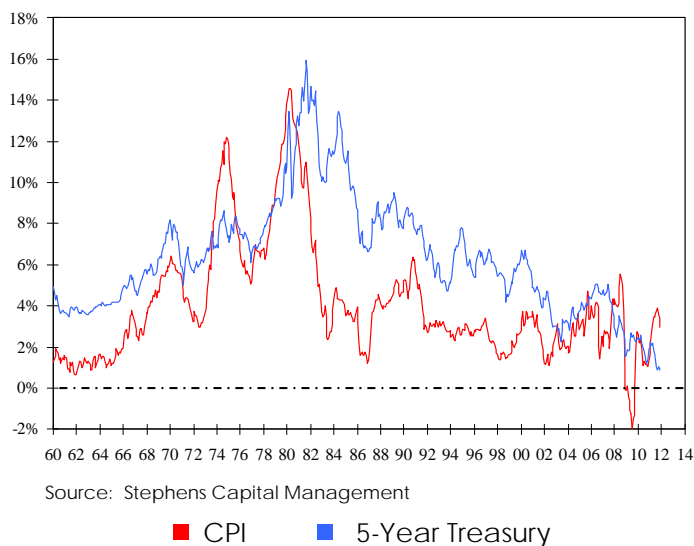


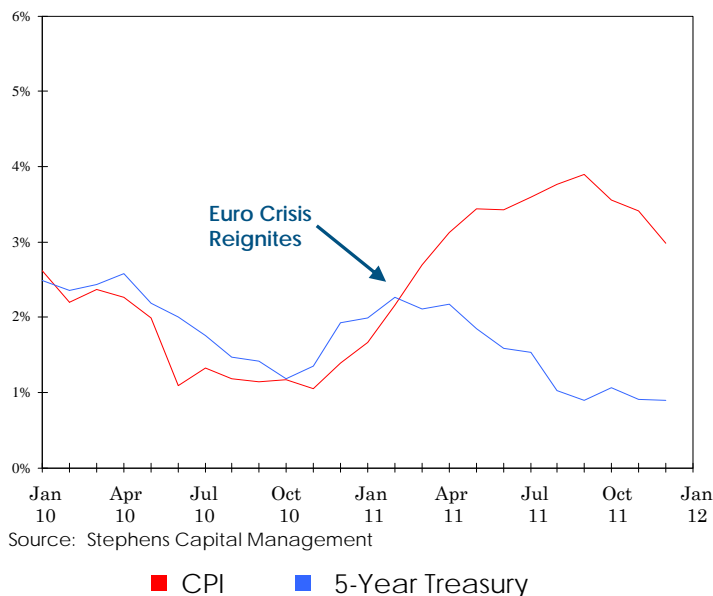
Since the early 1980's, we have managed our intermediate government bond strategy in large part by trying to anticipate inflation, as we believe inflation is the primary determinant of interest rates in the long-run. As the enclosed chart showing our analysis of the five-year Treasury rate vs. CPI shows, one can see that during this period they have tended to rise and fall together. This methodology has worked well and we were able to build a long term track record in periods prior to 2011 in which we bettered our benchmark index for 3, 5, 10, 15 and 20 years. But in 2011, factors other than inflation became more dominant in affecting the movements in interest rates.

CPI (Inflation) vs. 5-Year Treasury Yield



Inflation bottomed in November of 2010 at approximately the time we had anticipated. The rate of inflation was then 1.05%. The five-year Treasury closed that month at 1.18%. Anticipating a rise in inflation and a subsequent rise in interest rates, we shortened the duration of all of our bond portfolios at that time. As inflation began to rise, the five-year rates increased to 2.26% by February. At that point inflation and interest rates began an uncharacteristic divergence which we did not expect. Inflation continued to rise, ultimately peaking in September, 2011 at 3.90% before ending the year at 2.89%. Interest rates on the contrary fell markedly, dropping the five year rate to 0.89% at year end at which time investors were receiving a negative real yield of -2.00%.

CPI (Inflation) vs. 5-Year Treasury Yield
January 2010 – December 2011



The causes of this unusual divergence between inflation and interest rates were two fold. First was the resurgence of the sovereign debt crisis in Europe this past spring. Investors became no longer confident that debt of sovereign European countries would be repaid or even if the Euro would continue to exist as a currency. This caused a massive flight to safety into U. S. Treasuries driving prices up and yields down. Superimposed on this condition was a new policy from the Federal Reserve on September 21, 2011 in which they announced their intention to purchase \$600 billion of longer dated bonds in their portfolio in an attempt to force interest rates lower further out the yield curve.

The combination of these actions resulted in the divergence shown above.

As we have written previously, our outlook for inflation is for a continued moderation in the first half of 2012. Normally this would dictate a strategy of lengthening portfolio durations in expectation of declining interest rates. But, with rates already 200 basis points below inflation, the likelihood of further declines appears remote. Furthermore, there are signs that the crisis in Europe may be approaching a solution with a combination of the European Central Bank and the International Monetary Fund supplying the necessary funding. The removal of that risk could stimulate an unwinding of the flight to safety trade and put upward pressure on Treasury rates.

Thus it will be our strategy to maintain our duration close to but slightly below the benchmark level as we feel rates are more likely to firm than to decline from these levels despite moderating inflation. After mid-year we expect the inflation picture to change and the probability is for rising inflation. In that environment it will be highly unlikely that rates will decline from these extraordinarily low levels. Hopefully inflation and interest rates will have begun to revert to their historical relationship by that time.



Important Disclosures

The views expressed in this commentary were those of the portfolio manager as of the publication date and are subject to change without notice. The performance data quoted does not reflect the deduction of advisory fees and other account expenses. Our advisory fees are available in Part II of our ADV or the appropriate brochure. Performance results represent past performance and do not guarantee future results. Market volatility can significantly impact short-term performance. Actual results of an investment made may differ from the composite results, depending on the size of your account, the duration of the account, the investment objectives and/or restrictions, the time at which your investments are made, and other factors.

William Tedford has developed and uses a proprietary model designed to forecast inflation. The model reflects past and historical relationships of inflation to monetary base and oil prices. The future behavior of inflation is influenced by many factors (many of which are themselves unpredictable) and will not necessarily continue to follow historical patterns. The model, by itself, cannot guide an investor as to what securities should be bought or sold nor as to when to buy or sell.

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