

QUARTERLY ECONOMIC UPDATE

JULY 1, 2010

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Pervasive Pessimism Double Dip or New Opportunities?

You see and hear the news every day – housing numbers are abysmal, job creation is anemic, oil continues to spew in the Gulf, and Europe is a mess. Stocks have been falling and interest rates have plummeted. You have just experienced one of the worst economic and market downturn in years, and you certainly don't want to experience it again. Is it time to fold up our tents and go home, or should we be looking at the future with positive expectations?

Our answer is that we believe this is a time of excellent investment opportunities. We can't say things will turn positive in the markets today, but we do believe that this is exactly the wrong time to let emotions get the better of us. We know many of you are probably thinking that we're either insanely optimistic or just insane. But let's review the facts and see if we can strip away the noise.

At quarter's end, the S&P 500 was down 15% from its peak and the 10 year U.S. Treasury yield had fallen from an April high of 4.0% to 2.9%. The markets seem to be projecting a double dip recession – but why? Many of the early signs of recovery have appeared to

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Economic Statistics

| | 2nd Qtr (6/30/10) | 1st Qtr (3/31/10) | % Change | 1 Yr Ago (6/30/09) | % Change |
|-----------------------------|----------------------|----------------------|-------------|-----------------------|-------------|
| S&P 500 Index | 1,030.71 | 1,169.43 | -11.9% | 919.32 | 12.1% |
| 10 Year Treasury Yield | 2.93% | 3.83% | | 3.53% | |
| Gold Spot (\$ / oz) | \$ 1,242.25 | \$ 1,113.25 | 11.6% | \$ 926.60 | 34.1% |
| WTI Crude Oil (next future) | \$ 75.63 | \$ 83.76 | -9.7% | \$ 69.89 | 8.2% |
| GDP Qtr / Qtr | N/A | 2.7% | | -0.7% | |
| CPI Y / Y | 2.0% (May) | 2.3% | | -1.4% | |
| Unemployment Rate | 9.5% | 9.7% | | 9.5% | |

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reverse of late. For example, housing starts which declined by over 75% between the 2006 peak and March 2009, steadily rose until this past April before declining 9% in May. Similarly, after significant declines every month in 1990, jobs at private companies started increasing this past January. After rising by 241,000 in April, private payrolls only increased by 116,000 between May and June combined. These disappointing economic results seemed worse because up until April, the United States appeared to avoid the fate of Europe which has been mired in a

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sovereign debt crisis ignited by Greece. Suddenly, fears regarding budgetary woes among the individual states and large Federal deficits have come to the forefront. As if to add insult to injury, the lack of progress in Afghanistan and the inability to contain the oil leak in the Gulf of Mexico has created a negative psychology that is eerily reminiscent of the 1970s.

With all these reasons to be pessimistic, what is it that we see that causes us to be optimistic? For starters, the recent slowdown is neither unexpected nor unusual. As the nearby chart shows, interim slowdowns are the norm in the midst of an expansion. Yes, the housing numbers are not encouraging. But, given that housing was overdone prior to the recession and that an important tax break has come to an end, the drop in home sales should come as no surprise irrespective of lower mortgage rates now available. The markets are also focusing on weak job growth – but weak is not the same as negative. This is important because weakness in consumer spending isn't so much caused by the lack of spending by those without jobs. The bigger issue is the level of spending by those with jobs. While we have little faith in sustained growth in big ticket item expenditures, we do believe that American consumers will continue to spend – even after they pay down credit cards and other debts.

Pursuing the issue of employment further, the fact is that most companies do not need employment growth to improve their earnings. We've stated for some time that we expect strong demand from an emerging middle class in countries such as Brazil, China, and India.

Combined, these three countries have a population of approximately 2.8 billion people, while the U.S. has a population just in excess of 300 million. While exports have driven much of these countries' growth, their success combined with strong national balance sheets should drive internal demand going forward. Such foreign demand should benefit many U.S. corporations directly. For example, one of our clients' holdings, Caterpillar (CAT), is typically conservative regarding its public pronouncements. Yet in June announced CAT announced that it expects 25% revenue growth this year including 65% growth in exports.

U.S. corporations also have tremendously strong balance sheets. It is estimated that nonfinancial U.S. corporations, hold approximately \$1 trillion of cash. With capital expenditures, including information technology expenditures, deferred for the past several years, we could see a strong rebound in spending in the coming quarters. Meanwhile, inventories are still at very low levels. Though inventory reductions had exacerbated the down side of the economy, we believe that restocking has only recently begun to help the upside. As an example, box shipments are an indication of industrial production and trends in

GDP Performance After Recessions

| | Last Negative Quarter | Interim Peak | Interim Trough | Re-Acceleration |
|-------------------------------------|-------------------------|------------------------|------------------------|------------------------|
| Quarter Ending GDP Growth | Sep '82 -1.5% | Jun '83 9.3% | Jun '85 3.4% | Sep '85 6.4% |
| Quarter Ending GDP Growth | Mar '91 -1.9% | Jun '91 2.7% | Dec '91 1.6% | Mar '92 4.5% |
| Quarter Ending GDP Growth | Sep '01 -1.1% | Mar '02 3.5% | Dec '02 0.1% | Sep '03 6.9% |
| Quarter Ending GDP Growth | Jun '09 -0.7% | Dec '09 5.6% | ? ? | ? ? |

inventories. Another of our clients' holdings, Temple-Inland (TIN) reported that in the 1st quarter industry box shipments were up 2% after being strongly down for most of 2009. In April, box shipments were up 5%. There is still a long way to go. Finally, U.S. corporations have been incredibly efficient. Productivity has increased for eight

consecutive quarters. In fact, this strong productivity growth is part of the (though not the only) reason why there has been so little job growth in recent months. What's good for companies – and by extension shareholders – is not always good for individuals.

Now let's shift gears and discuss valuations. While stock prices and interest rates have been falling, corporate earnings have been rising. In fact, after tax corporate profits have risen over 30% year over year in both the 4th quarter of 2009 and 1st quarter of 2010. As a result, the price earnings ratio (P/E) of the S&P 500 was below 15 at quarter end. This is the lowest ratio since the end of April 2009. Prior to the recession, we have to go back to the end of 1990 to see such levels. But what does a P/E of 15 really mean? It means that for every dollar we pay, net income equals 1/15th (or roughly 6.7%) of our investment. By comparison, a 10 year Treasury bond yields approximately 2.9%. In our opinion, this makes stock valuations very attractive relative to bonds. Once again, we have to go back to April of last year to see such a wide differential. And, looking back prior to this recession, we have to go back all the way to the late 1970s to see a differential so wide. We've thrown a lot of concepts and statistics out, but in a nutshell, we're saying that stocks are inexpensive relative to earnings and to available interest rates. And, we think that earnings can go even higher. If we are correct, then stocks prices can advance even before valuations improve.

Equity Strategy

With the equity markets off from their highs, the obvious question is: shouldn't we be getting out of stocks and wait things out until the situation improves? The simple answer is that our focus is on our clients' long-term investment objectives. We are not short-term market timers. Of all the great investors we have studied – Benjamin Graham, T. Rowe Price, Warren Buffet, etc. – we know of none who has attempted such a strategy. This does not mean we will not ever reduce equity holdings or question our assumptions. It does mean that our focus has to be on our investment strategies and pricing disciplines informed by our economic and company specific forecasts. As we stated above, we believe that in general, equity prices are inexpensive and the outlook for individual companies is quite positive.

Since early 2009, we have been positioning equity portfolios with relatively high exposures to technology and industrial companies. Later in the year and in early 2010, we started increasing holdings of companies that are direct beneficiaries of emerging market consumer demand. We've limited purchases of companies dependent on consumer big ticket items and financial companies. With respect to the latter, we had been concerned that the downside risk we saw in 2008 and 2009 was not eliminated. On the other hand, we thought that the upside opportunity might be reduced if financial institutions became the target of government actions and new regulations. With the new Financial Regulation ("FinReg") bill emerging from Congress, we believe we were right to be cautious. Overall, the portfolio moves resulted in strong returns for 2009 and early 2010, though in the second quarter we gave back some of those gains. It is obviously frustrating to not see positive results, but we believe the longer term positioning is correct. As a result we made no major shifts in equity portfolios despite the market correction.

Based on positive growth outlooks and very low valuations, we believe the technology sector remains the single most attractive sector of the market at this time.

Turning our attention to technology stocks in the portfolios, personal computer and smartphone demand has remained strong. Nonetheless, Microsoft (MSFT), Intel (INTC), and Micron Technologies (MU) all lagged the markets despite generating extremely positive earnings results. With such attractive valuations and our outlook unchanged, we remain committed to these stocks. In fact, based on positive growth outlooks and very low valuations, we believe the technology sector remains the single most attractive sector of the market at this time. Later in the year, we expect corporate spending on information technology to pick up as well. Not only should the above three companies benefit, but so too should companies such as EMC Corp. (EMC), which was up for the quarter and year-to-date, IBM Corp. (IBM) and Hewlett-Packard (HPQ). The latter two companies we recently began purchasing for clients who have available cash.

As a result of strong demand in emerging economies, continued rebuilding of inventories, and improved overall economic activities, we expect the industrial side of the U.S. economy to outperform the consumer side for the next several years. With valuations attractive, our clients hold positions in such companies as Caterpillar (CAT), FedEx (FDX), Temple Inland (TIN), Timken (TKR), ITT Corp (ITT), United Technologies (UTX), General Electric (GE) and Norfolk Southern (NSC). Performance among these industrial companies has been a mixed bag. While CAT outperformed the markets in the second quarter and is still up nearly 4% year to date, FDX underperformed the S&P 500 in the quarter and is down over 14% year to date. As investor sentiment has turned sour on the economy, it is not surprising that those companies most directly impacted by economic activity would react sharply. While acknowledging that the pace of economic growth has slowed for now, we do not buy into the notion that we are heading back into a recession. As such, we remain committed to these positions as well.

Perhaps the area where we were most disappointed in the quarter was the performance of those companies driven directly by domestic demand in foreign countries. While Embotelladora Andina (AKO/B) and Brasil Foods (BRFS) outperformed, China Security and Surveillance (CSR) significantly under performed. The stocks of such foreign companies tend to be more volatile than those of U.S. domestic companies. As such, we generally maintain smaller portfolio positions. We've reviewed the underlying positioning and financial performance of these companies, and we think they still represent excellent opportunities.

Going forward, we will continue to monitor portfolio companies carefully. We will pay particular attention to second quarter results for indications that either our forecasts are proving correct or that we need to make adjustments. While we would not be surprised if sentiment remained negative for a while, neither would we be surprised if there were a strong upward movement. After all, at the depths of the equity market performance in March of 2009, who would have thought that the S&P would finish the year up 26%?

Fixed Income Strategy

Just when we thought interest rates were as low as they could go, rates went down further. At the end of November, 2009 the 10 year U.S. Treasury bond reached an interim low of 3.2%. With economic activity apparently picking up and U.S. deficits expanding, the rate gradually increased to 4.0% in early April of this year. Then the Greek debt crisis threw the Euro into turmoil, and the 10 year rate plummeted to 2.9%. Interest rates on corporate securities fell as well, but not to such a great extent. The simplistic reasons for the decline in interest rates are that the U.S. dollar has resumed its role as a safe haven and investors now believe the U.S. economy will remain weak.

This general interest rate movement is significant for our clients for several reasons. First, as interest rates fall, bond prices generally go up. Bonds with longer maturities tend to move more than those with shorter maturities. Of course the opposite is true when rates rise. Bonds with longer maturities fall more than those with shorter maturities. As we have generally kept maturities under 10 years, bond portfolios have not appreciated as much as if maturities were longer. Second, and perhaps more significant, reinvestment opportunities have become very limited. As interest and principal payments are received, the opportunities to generate significant income with that cash are few and far between.

The questions are, should we 1) extend maturities to get higher interest rates for our clients or 2) purchase more risky fixed income securities that pay higher rates? We believe the answer in both cases is an emphatic "NO". We believe that preservation of capital in fixed income portfolios should be our number one priority at this time. Whether it be in fixed income or equity markets, we've seen more money lost when investors ignore risk and/or chase returns. While we would like to say there is an easy way to increase income and preserve capital, at this time we don't believe there is.

We don't know when interest rates will rise. At some point, we believe they will. We originally thought rates would rise by the second half of 2010. While they may start rising at any point, we believe that for interest rates to resume rising, either the Euro crisis will have to work its way to some sort of resolution or evidence of economic growth in the U.S. will have to become more pronounced. We have faith in economic growth, and hence rising rates. But, the markets will have to determine when this occurs.

