Q1 2010

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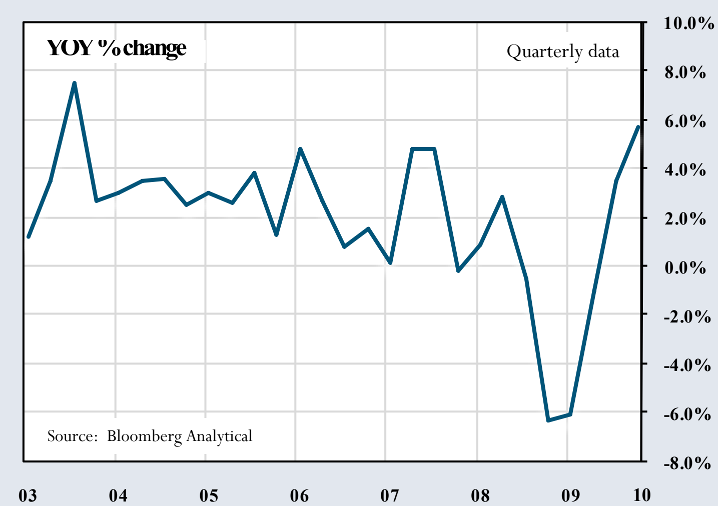
INVESTMENT *perspective*

Investors put any remaining concerns over the financial crisis or significant worries about a “double dip” in the economy behind them, and the rally in the financial markets continued in the first quarter. The S&P 500 Index rose 5.4%, and with the growing consensus that the economic recovery is becoming self-sustaining, cyclical sectors such as Industrials, Financials and Consumer Discretionary led the market with double digit gains. Treasury yields were basically unchanged during the quarter, but tightening spreads in the Corporate, Agency and Mortgage sectors added to fixed income returns, with the Barclay’s Aggregate Index up 1.8%. While investors have been highly rewarded for assuming risk over the past year, the returns going forward will likely be lower and more volatile. However, equity and debt markets remain in the “sweet spot” of accelerating economic activity combined with fiscal and monetary stimulus and the outlook remains generally positive.

U.S. Real GDP



Evidence of improving economic conditions has been broadly based, with positive trends seen in employment, housing, and consumer spending. After two years of wrenching job losses, 162,000 net new jobs were created in March. Even after subtracting the 48,000 temporary census workers, the improvement in private sector jobs was encouraging, and the gains in manufacturing, construction, and temporary workers reflect continuing positive employment trends. The unemployment rate held steady in March at 9.7% as the labor force expanded basically in line with the growth in jobs. While the unemployment rate probably peaked last year at 10% and job growth is likely to continue, we concur with the consensus forecast that it will be years before the unemployment rate returns to mid single-digit levels. The political implications of this slow, grinding employment rebound will likely be a major factor in the mid-term elections, which are just seven months away.

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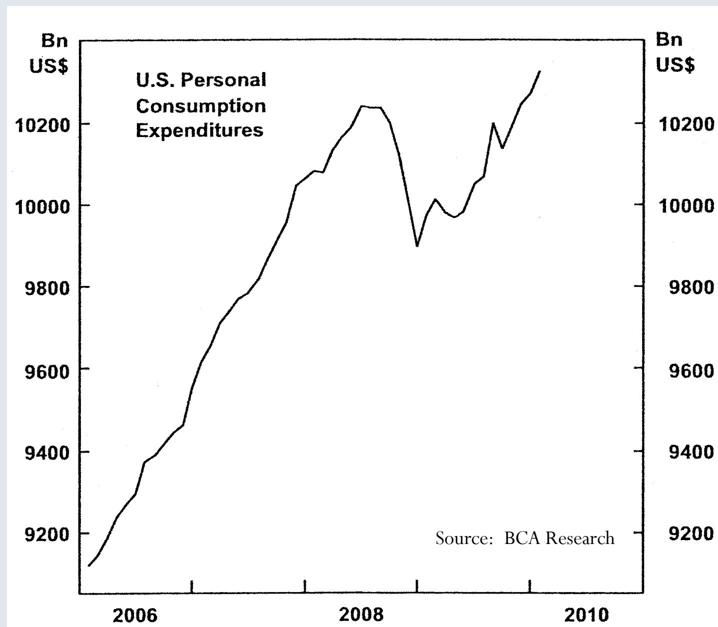
The housing sector data has been less consistent, with a strong 8.2% increase in pending homes sales in February after a -7.8% decline in January. The extension of the first-time home-buyers' tax credit, stabilizing home prices and low mortgage rates all drove mortgage applications higher in March. The Case-Shiller home price index in January showed a 3.9% gain in home prices since the trough, with all 20 metropolitan markets posting gains with the exception of New York which was flat. Although inventory levels remain elevated and the foreclosure rate high, anemic new housing starts, pent-up demand and the improving labor market should all help to reduce the risk of a renewed collapse in home values.

Consumption, which accounts for two-thirds of economic growth, has ticked upward given improving labor and housing conditions. March retail store sales increased over 3% from last year, and consumer spending for the first two months of the year was up at a 3.1% annualized rate. Savings rates, which surged in response to the financial crisis, appear to have peaked, and total U.S. personal consumption expenditures have been rising since April 2009 surpassing the pre-financial crisis highs.

Consumer Spending

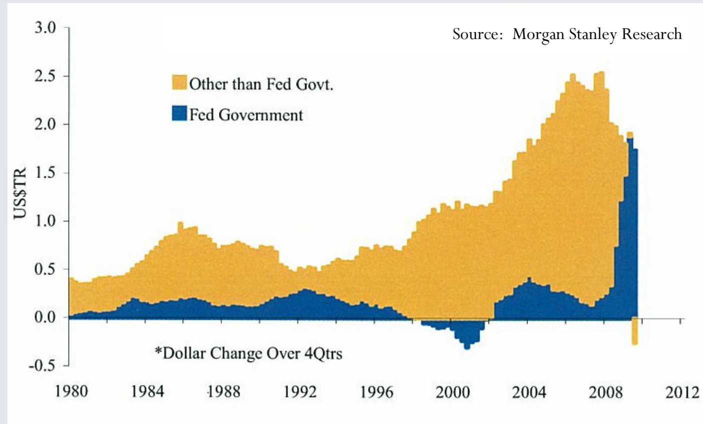


In addition to improving economic trends in the United States, developing economies are growing briskly. China in particular is expected to expand its GDP over 10% in 2010. To put China's influence in the global economy in context, it is estimated that the country has been responsible for 70% of the world's economic growth since 2007. In response to growing inflationary pressures due to overheated economic growth, Chinese (and Indian) authorities tightened monetary policies during the quarter. Rising commodity prices, including oil which is trading in the mid-$80's per barrel, is further evidence that the global economic recovery is gaining traction.

In contrast to the developing markets, economic conditions in Europe are tepid, and future growth prospects are constrained by large public debt levels. Much attention is focused on Greece, but other countries including Portugal, Spain, Ireland and the United Kingdom all face troubling public deficits. A default by Greece or any European Union (EU) member would call into question the EU's viability, a result that Germany and France are loath to permit. While the final rescue plan has yet to be unveiled, the backstop support offered by the EU combined with the International Monetary Fund is expected to avert a default. Greece will experience much pain as it deals with the economic reality that a country cannot continue to spend more than it takes in, and hopefully it will serve as a warning signal to other countries (including the U.S.) to maintain more disciplined fiscal policies.

A primary factor in the improving economic trends in the U.S. and abroad was the unprecedented level of intervention regulatory authorities implemented to counter the negative impact of the financial crisis. Now that conditions have stabilized and the economy is moving toward a self-sustaining recovery, we are closely monitoring the Federal Reserve for signs that its' "exit strategy" has begun. The Fed's final remaining special program of purchasing $1.25 trillion of mortgages concluded last month, bringing the Fed's balance sheet to $2.3 trillion. Chairman Bernanke has stated that over time the Fed will bring its balance sheet back to "pre-crisis" levels which would be under $1 trillion and to limit its holdings once again to Treasuries. The various tools under consideration to return to a normalized state include raising the interest paid on reserves that banks keep at the Fed, raising the discount rate, and selling assets such as mortgages. These tools will likely be implemented slowly to minimize any upward pressure on interest rates. Given the high unemployment rate, low levels of core inflation, high productivity rates and sluggish bank lending, the Fed appears to be in no hurry to change its accommodative policies. While the Fed will probably begin to drain liquidity from the system and increase the discount rate modestly in 2010, the Fed Funds rate may remain at or near zero until 2011.

Change in US Domestic Non-Financial Debt*



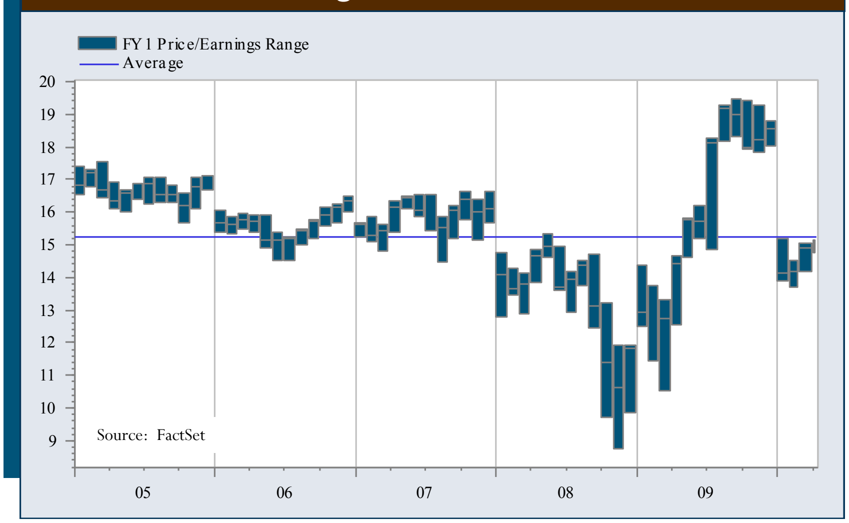
Bond investors, possibly concerned over the passage of the $940 billion healthcare bill and continuing unrestrained federal spending, have a somewhat less sanguine perspective than the Fed. The yield curve steepened to a record 291 basis points spread between the rate on two-year and ten-year Treasuries in mid February, and the ten-year Treasury recently flirted with the important technical yield level of 4%. We are positioning our fixed income portfolios with a shorter average duration, with most holdings in maturities less than five years and longer than eight years. This modified "barbell" structure should outperform the bond index as the yield curve returns to a more normal shape. Corporate credit spreads continued to narrow given the improving economy and investor demand for yield. The corporate investment grade index yields approximately 165 basis points over Treasuries, a level last seen in late 2007 before the crisis. We anticipate further corporate spread tightening as the recovery gains momentum, overall credit quality improves, and as demand for corporates continues given that other yield products (Agencies and mortgage pass-through securities) are at yields barely above Treasury securities. Tax-exempt bonds continue to perform well given limited supply and high demand for issuers with strong financial characteristics. Our portfolios which have a bias toward Texas municipalities benefit by the relative strength of the Texas economy as compared to the rest of the nation.

Yield Spread Between 2-Year and 10-Year Treasuries

Conclusion on back …

Equities were propelled higher given strong earnings momentum and growing confidence in the economic recovery. Consensus S&P 500 earnings in 2010 are estimated to increase about 40% over 2009. Early estimates for 2011 S&P earnings represent a further 20% increase from 2010 levels. Based on 2010 estimates, the broad market appears to be fairly valued with a price/earnings ratio of about 15, and looks attractive assuming 2011 earnings estimates are realized. The market rebound over the past year has been broadly based, but has been led by lower quality securities that benefited from short covering and higher risk appetites as the economy improved. While this low-quality leadership is not unexpected, we do not expect it to continue to the same degree it has in the prior four quarters, given now heightened earnings expectations, modestly rising real rates, and declining short interest ratios. We are very mindful that risks remain in this nascent economic recovery, dependent as it has been in the initial stages on unprecedented fiscal and monetary actions. As the recovery strengthens, we continue to add more cyclical exposure to our equity portfolios and to maintain our focus on companies with pricing power given their unique product line and/or highly competitive market position.

S&P 500 Price/Earnings Ratio



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