Q2 2010

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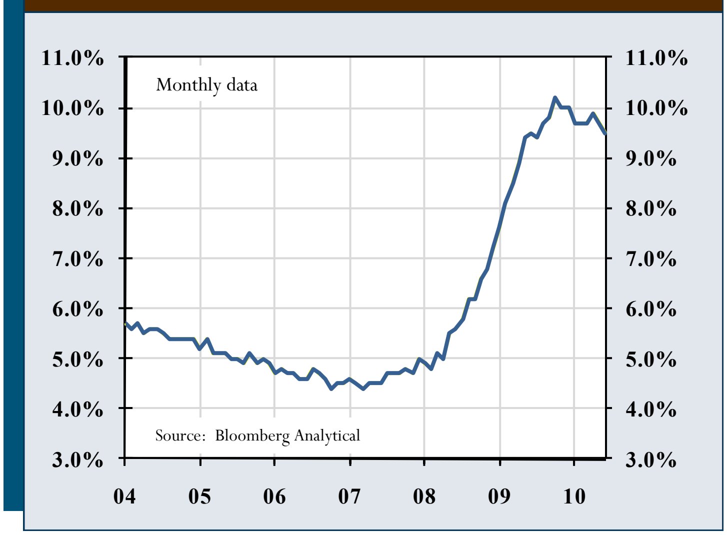
INVESTMENT *perspective*

Investor concerns over the European sovereign debt and banking issues, slowing economic growth both here and abroad, and heightened uncertainty surrounding regulatory policies all combined to sharply reverse the thirteen month stock market rally in the second quarter. The S&P 500 Index declined 11.4%, and while credit markets were shaken similar to equities, the Barclays Aggregate Bond Index was up 3.5% as investors moved to reduce risk and plowed funds into U.S. Treasuries. Investor sentiment has been significantly eroded, and volatility has reemerged given that the outlook for the economy and the financial markets has become more clouded.

After experiencing improving economic conditions for a number of quarters, recent economic data has been disappointing. Private employment growth in May and June has averaged about 60,000 jobs per month, approximately one-half the rate required to *maintain* employment levels given the growth in the workforce. The decline in the unemployment rate to 9.5% as of the end of June from 9.7% was primarily due to over 650,000 people exiting the workforce given the expiration of extended unemployment benefits and a growing mismatch between skills required and the available jobs. Employment markets will continue to be impacted by structural issues such as (1) the likelihood of further job losses in government positions as states and local municipalities confront budget shortfalls, (2) older employees are not leaving the work force due to a severe contraction in their retirement savings from the bear market, and (3) workers are less mobile due to the housing crisis, as houses are either not sellable or far under water preventing employees from moving to take a new position. Furthermore, employers are reluctant to add full-time employees given such a cloudy and potentially negative outlook on demand levels, health care costs and tax rates. On a positive note, temporary employment continues to expand, which typically portends a pickup in permanent positions. Additionally, total labor income for production and supervisory workers increased at an annualized rate of 4.1% since the start of the year, reflecting stable to tight labor conditions for this component of the labor force which has a significant impact on consumption levels.

Unemployment Rate



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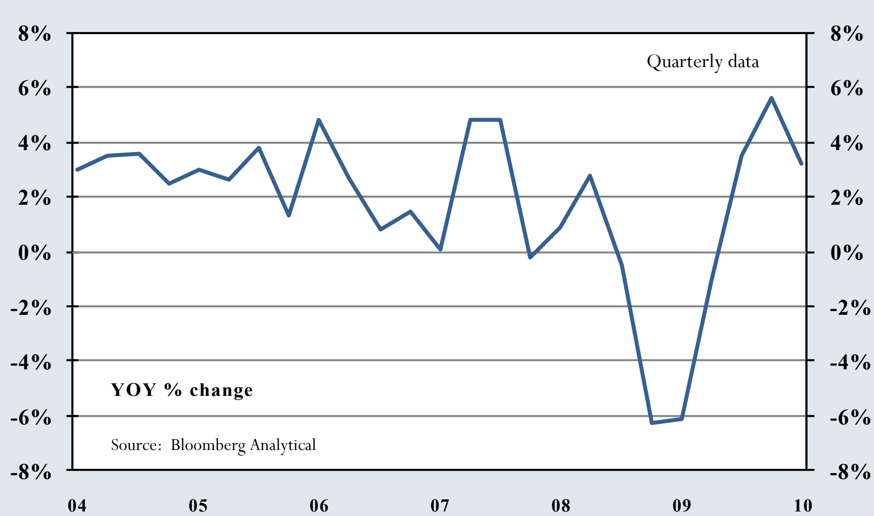
Housing and construction sectors continue to be weak. With the expiration of the housing tax credits, pending home sales fell 30% in May, and mortgage applications fell a precipitous 52% since April. The S&P/Case Shiller home price index rose 0.4% in April, but it was most likely propped up by buyers hurrying to take advantage of the tax credit. May data will likely be softer given sluggish conditions and the tax credit expiration.

The two closely watched measures of economic activity from the Institute of Supply Management (ISM), the nonmanufacturing and the manufacturing ISM indices, both fell in June providing further evidence that the economy is losing momentum. The two indices were still over 50%, which indicates expanding conditions, but were lower than consensus expectations. Consumer confidence levels published by the Conference Board fell almost 10 points in June to 52.9%, with particularly low readings in the South which has borne the brunt of the disastrous oil spill.

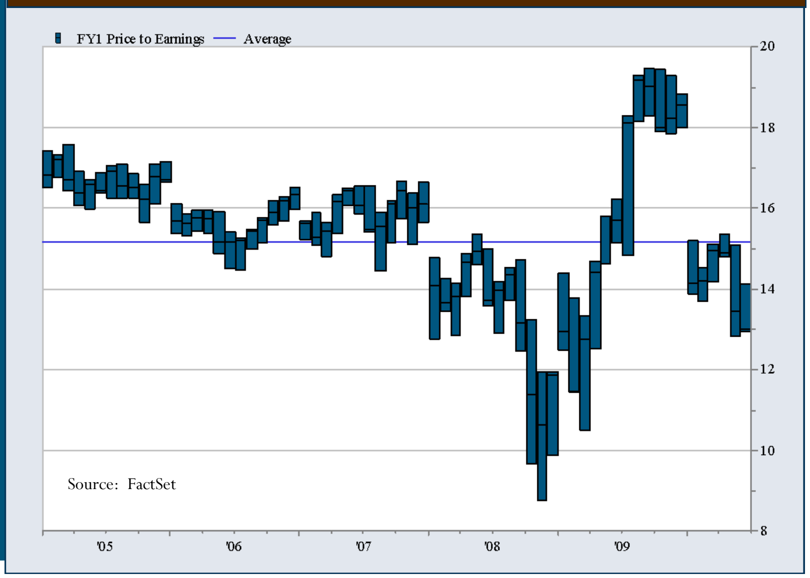
In sum, while the rate of growth has slowed, the economy is transitioning from an inventory rebuilding, stimulus induced growth cycle to a more private sector, demand driven phase. Unfortunately, this transition is happening concurrent with policy actions which are viewed to be unsupportive of private sector job creation and capital deployment, together with continued banking and growth concerns in Europe and China. This has led to a very high level of uncertainty, and potential policy changes will remain unclear until after the November elections. The currently proposed financial regulation reform will require material increases in capital at regulated financial institutions and industrial companies that hedge certain operating costs. In response, regulated financial institutions are continuing to ration credit and retain earnings to build sufficient capital. Corporations are raising cash balances in order to self- finance their business strategies and ensure they do not experience a liquidity squeeze. Despite the recent trends, our working assumption is that the economy will continue to experience growth, albeit slow and "choppy".

U.S. Real GDP



In addition to the sluggish U.S. economy and lack of transparency in key policy areas such as health care, financial regulation, taxes and energy, the volatile markets also reflect great uncertainty over whether deflationary or inflationary forces are the greater threat going forward. Until the middle of the quarter, investors were positioned for a reflationary environment, and the flight to safety and accelerating deflationary pressures caught investors off guard. The "flash crash" of May 6th was indicative of this positioning and the rapid change in sentiment. The austerity programs being implemented in Europe in response to their sovereign debt problems, and China's steps to slow its economy, particularly its overheated property market, are two major deflationary trends, as is the continuing deleveraging process underway globally. Ben Bernanke, a Japan and deflation expert, is particularly well-qualified to address this threat, and we believe he will direct the Federal Reserve to reengage in aggressive quantitative easing should economic conditions deteriorate. Constructive fiscal and regulatory policies coming out of Washington, however, are far less certain.

S&P 500 Price/Earnings Ratio



Equity markets performed poorly across the board in the second quarter, with all industry sectors declining in the period. Based on current valuations, the markets are discounting an economic slowdown, but are not anticipating a recession. Earnings expectations for the S&P 500 of roughly $75-80 per share for 2010 appear reasonable assuming the economy does not experience a "double dip." What is far less clear is what appropriate multiple to place on these earnings. Given the very low level of interest rates, one could argue for a multiple in the "teens"; however, given the large structural deficits which loom ahead, a multiple in the high single digits could be equally justified. Given this uncertainty, we have shifted to a more defensive position in our equity portfolios and have added companies where we have higher confidence in their ability to grow earnings even in a soft economy. We remain focused on companies that have better pricing power, lower earnings variability, higher profitability and stronger balance sheets than the broad investment universe, qualities that should allow these companies to successfully gain market share should the economy continue to slow.

In our taxable fixed income portfolios, the "flight to safety" during the quarter resulted in a widening of the investment grade risk premiums, but was offset by declines in Treasury yields. We believe corporate bonds offer attractive values and we remain positive on the overall credit improvement occurring in the corporate sector given strong earnings trends and enhanced liquidity. Cash levels at investment grade companies have increased 15% and debt levels have decreased 2% from a year ago, and more companies received ratings upgrades than downgrades in the first quarter for the first time since 2007. While Treasury yields have declined over the past several months due to the issues described herein, and may remain low for awhile, we believe the greatest threat to bond portfolios over the next few years will be rising interest rates, and therefore we will continue to maintain a modestly shorter duration than relevant benchmarks.

Conclusion on back …

For taxable investors, municipal bonds remain attractive relative to Treasuries and high quality Corporate bonds. As states and municipalities struggle with budget shortfalls, municipal bonds will continue to be subject to headline risk. According to research from Deutsche Bank, for most states, even those with the most stressed budgets, debt service costs are a small part of the states' budgets. In addition, debt service on general obligation debt in most states is senior to almost all other expenditures, making the risk of default low. In order to minimize any such risk, we focus on issuers with taxing authority, issues supporting essential services, and maintaining very high credit quality through our proprietary research and an emphasis on Texas issuers.

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