Q2 2011

VAUGHAN NELSON INVESTMENT *perspective*

The volatile financial markets in the second quarter were a clear reflection of the exceptionally high level of uncertainty which exists among investors. Weaker than expected recent economic data in the U.S. combined with inaction on critical Federal budget issues, the end of the Federal Reserve's quantitative easing program and lack of clarity on financial and healthcare sector regulations has created a "wait and see" attitude among business leaders and market participants alike. Globally, debt problems in nations such as Greece, Ireland and Portugal continue to fester, China is implementing policies to slow its economy in order to tame mounting inflationary pressures and any near-term bounce from the Japanese supply chain is likely to be short lived. As such, we expect economic growth will be below trend and choppy over the next several quarters.

The most critical of all economic metrics and the best proxy for sustained confidence among business leaders is employment data. After two months of solid non-farm payroll growth in March and April which averaged over 200,000 net new jobs, the May and June employment reports were disappointing with only 25,000 and 18,000 jobs created, respectively, and the unemployment rate in June increased to 9.2%. Government employee layoffs in June totaled 39,000, and with states and municipalities slashing budgets to reflect lower revenue levels, more government related jobs will be trimmed in the months ahead. Additionally, as we hear continually from company managements, there is little interest in hiring new employees and embarking on new projects until future aggregate demand and the regulatory environment become clearer.

Unemployment Rate

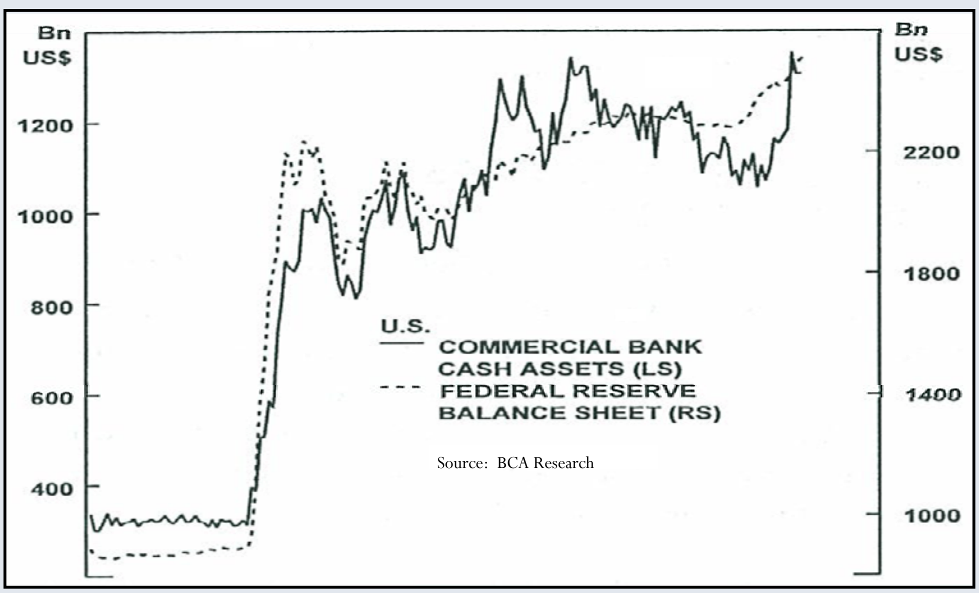
The weakened employment picture was accompanied by softer domestic economic data across the board. Higher gasoline prices during most of the second quarter had a negative impact on consumer spending, with particular weakness in durable goods which was down 1.7% on a real basis in May. Light vehicle sales dropped to an annualized rate of 11.4 million vehicles in May after reaching the 13 million level earlier in the year, as inventory levels in the U.S. declined due to Japanese supply disruptions.

Housing prices continued to fall, although the rate of decline in the widely followed S&P/Case Shiller Index slowed in April. Reflecting both tighter credit standards and concerns that housing prices may continue to fall, the mortgage applications index has been trending sideways over the past several months despite very attractive mortgage rates. According to BCA Research, U.S. households have lost almost $900 billion in housing-related wealth over the past 12 months.

On a positive note, the decline in real estate has been more than offset by a gain in financial assets, estimated by BCA to have increased by $3.4 trillion over the past year. Households have also improved their debt balances. In 2007, U.S. households collectively had debt to annual income levels of 127% and as of the first quarter the ratio had fallen to 112%. To put the level in context, the debt/income ratio in the 1990's averaged 84%, therefore, further household deleveraging will continue to be a headwind for the economy for the foreseeable future. Overall, households' net worth is still about 12% below its recent peak in 2007, but has increased by about 20% since bottoming in 2009.

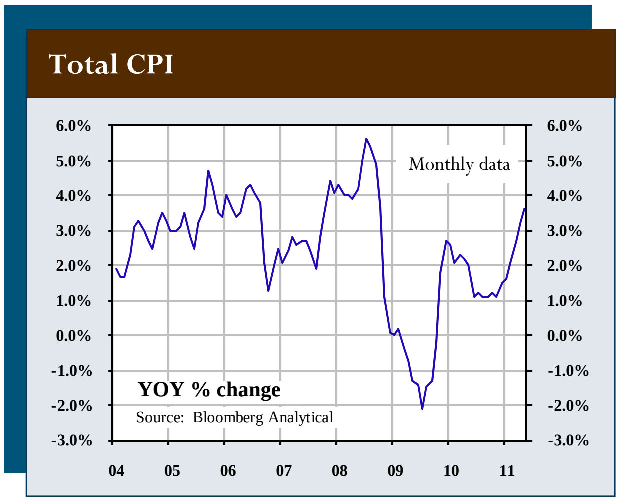
The primary driver of the rebound in financial assets over the past year was the Federal Reserve's controversial second round of quantitative easing (QE2), which Chairman Bernanke outlined in a speech in Jackson Hole last August and which ended as scheduled last month with the final purchases of $600 billion of Treasury securities. Despite the current economic soft patch, the Fed has been very clear in its communications that there are no plans for a "QE3" program. However, the Fed appears to be in no hurry to begin the process of tightening monetary policy. In an attempt to enhance the transparency of the Fed's actions, Chairman Bernanke has instituted periodic press conferences, and in his most recent one he indicated that the Fed would not raise interest rates until November at the earliest, and that the Fed would maintain its portfolio of more than $2 trillion of Treasury and mortgage-backed securities by reinvesting principal payments for an unspecified time period.

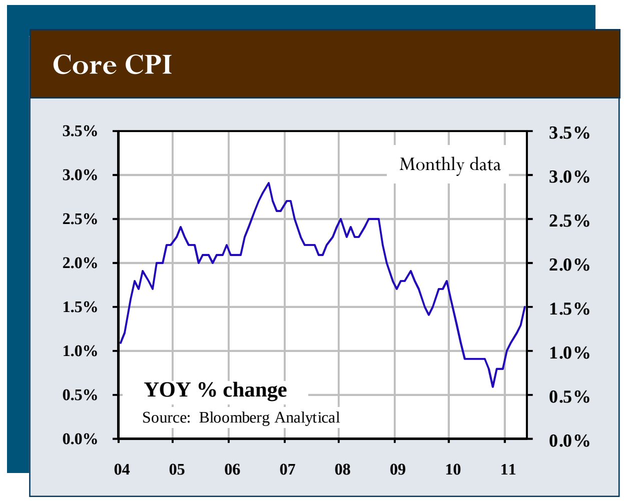
Federal Reserve Balance Sheet



Source: BCA Research

The dual mandate of the Federal Reserve – to maintain price stability and full employment – requires the Fed to walk a very difficult and fine line as compared to other Central Banks which are charged exclusively with maintaining stable price levels. In addition to creating financial asset appreciation, QE2 spurred significant commodity inflation. While commodity prices have recently eased, core inflation trends have worsened, and excluding food and energy, CPI rose 1.5% year-over-year in May, and is up 2.5% on a three month annualized basis.



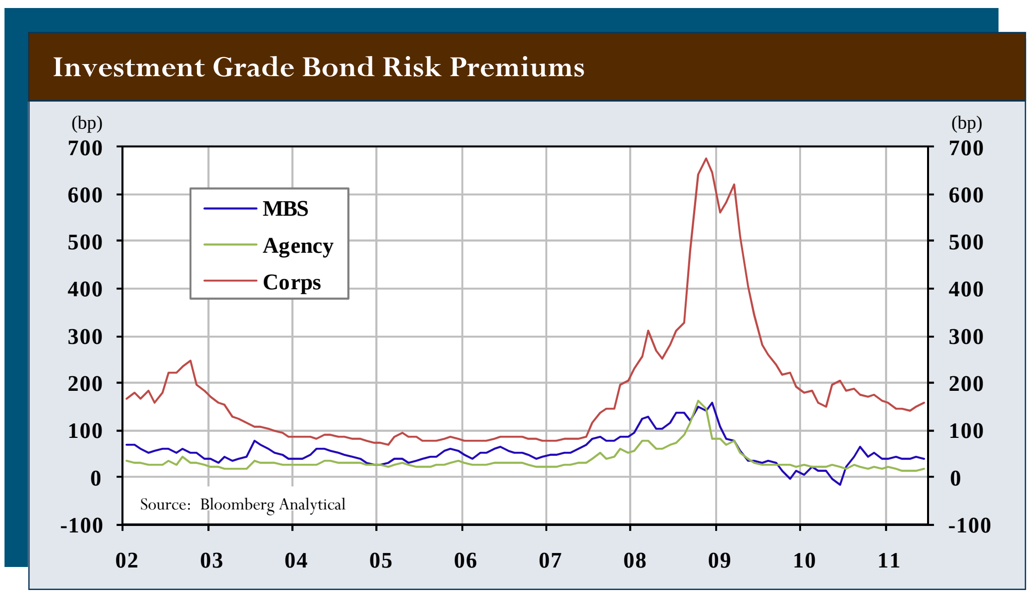


The economic and political travails of Greece contributed to investor anxiety during the quarter. While the Greek Parliament passed the austerity program forced upon it by the European Union by a slim margin of 62 to 61, the intractable problems of the highly indebted nation with limited resources were merely "kicked down the road." The markets are concerned about another potential financial crisis sparked by a sovereign default which could impair the European banking system. Current European political leaders are united in their resolve to take whatever steps are necessary to avert a breakup of the Euro zone, but there will be more pain and volatility ahead as the debt issues are slowly resolved. A possible silver lining for U.S. markets is the potential for market share gains by American- based global financial institutions at the expense of their European competitors.

Another source of great uncertainty is the highly partisan debate in Washington over the debt ceiling limit. As the early August deadline approaches, there are some encouraging signs of a possible compromise between the two parties, with Democrats considering entitlement and tax reform options in exchange for Republican support for some tax revenue increases, not through tax rate increases, but rather through the closure of selected subsidies and loopholes. While neither party wants to bear the blame for a U.S. default and we expect that outcome to be averted, we believe that any substantive progress in the structural deficit issues will be delayed until after the 2012 elections.

After a very strong first quarter, equities were flat to down in the second quarter. In addition to the historic accommodative monetary policy, equities have benefited from strong corporate earnings growth. In 2010 S&P 500 earnings per share of $84.70 were up 28% over 2009 levels, and consensus estimates for 2011 call for EPS to increase to $100, for year-over-year growth of 18%. Given our more cautious macro economic outlook, we believe there is a risk of downward revisions to current earnings estimates. We have structured our equity portfolios accordingly, and continue to identify companies which can potentially achieve fifty percent appreciation over three years due to their superior growth prospects, attractive valuations and/or current yields. Our equity portfolios have higher levels of profitability as measured by return on assets and higher predictability of their earnings than the market. We still do not favor any single industry sector, and continue to look for the characteristics noted above across all industries. The Federal Reserve's expressed intention to raise inflation expectations and exit nonconventional policy actions could result in material unintended consequences. As such, we will remain vigilant of the macro risks that could impact specific industries and business models and are prepared to reposition equity portfolios accordingly.

Bonds outperformed equities in the second quarter as the "risk on" trade finally took a breather after several very strong months of performance. Triggered by the European sovereign debt crisis and slowing economic growth, Treasuries rallied as investors became more risk averse. Investment grade bond yield spreads versus Treasuries widened modestly (from +150 basis points to +165 basis points), but corporate bonds benefited on an absolute return basis by the price appreciation of the underlying Treasuries. We project that spreads will narrow to the +125 level by year-end given diminishing concerns over a Greek default, very healthy corporate balance sheets and moderate economic growth. Our bond portfolios are positioned for a modest rise in interest rates with a shorter average duration than the relevant benchmarks.



One of the best performing markets in the second quarter was the municipal bond market. With the lack of any material defaults since the now infamous call by a well known market strategist that there would be "hundreds of billions" in municipal defaults, together with the fact that most state and local taxing authorities must balance their budgets annually, the fear of a municipal market meltdown has greatly subsided.

VAUGHAN NELSON

600 Travis, Suite 6300
Houston, Texas 77002-3071

713.224.2545
888.888.8676
713.228.4292 fax

www.vaughannelson.com

PRESIDENT AND CEO
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