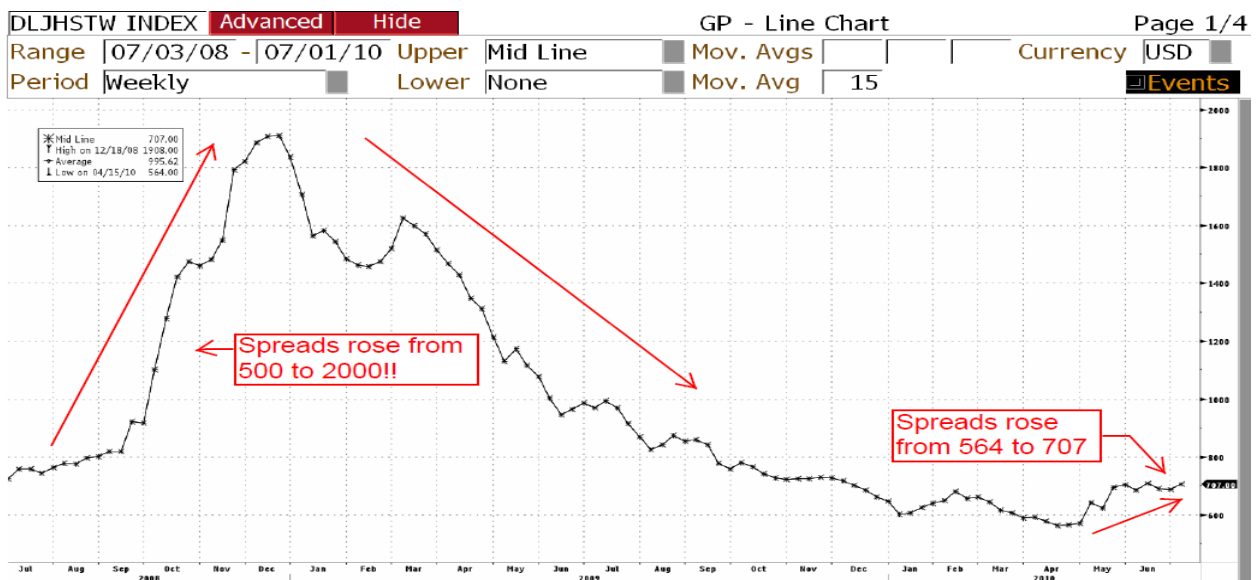


Commentary - 2nd Quarter 2010

The summer of 2010 may become known as the “Great Awakening”. The credit crisis that hit the financial system in 2008 has progressed to sovereign debt in 2010. The “bond vigilantes” we spoke about in a previous letter have raided the government bond markets of the weak members of the European Monetary Union. Sovereign debt credit risk is now on everyone’s radar. The deficit problems of Greece spread default fears to other big spending government bond markets in Europe including Portugal, Spain, Ireland, and Italy. Austerity programs are the new fashion rage in Europe. Ironically, the pressure to reduce government spending will be good for the markets in the long run because more resources will be available for the private sector to use more efficiently. But first we must endure the anguish that a frayed government social program safety net will have on consumer confidence.

The U.S. stock market reached its high for the year in late April. Wouldn’t it have been nice to act on the old adage of “sell in May and go away”? Markets always over-react in both directions. The market sold off too much in the spring of 2009 and appreciated too much in the spring of 2010. Too many good expectations were priced into the market in April for the market to continue rising. But now, expectations are too weak. Everyone is worried that we will return to the depths of 2009. We do not believe that will happen because credit market conditions have improved so much over the last year. It is time to bring back the graph of yields on the high yield bond sector versus U.S. Treasuries shown below. Spreads rose slightly, but they are nowhere near the terrifying jump of 2008.

Graph 1. Credit Suisse High Yield Bond Index Spread-to-Worst, Source: Bloomberg



The complete shut down of the economy in the 4th quarter of 2008 was due to the credit crisis. We are past the credit crisis now, corporate bond yields are much lower, corporate balance sheets are in much better condition, and the big money center banks have replenished their capital. The Maestro himself, Alan Greenspan, stated in an interview on CNBC this week that we are experiencing a pause in the economic recovery, not a double dip recession. The only way we could suffer another dip in the economy is through policy mistakes from Washington; like raising taxes, increased regulation, or restraining free trade. Unfortunately many of these risks are being proposed right now. Let's hope with election season coming that Washington will take a sabbatical, and investors will regain confidence in the free enterprise system's ability to dynamically overcome obstacles to growth and profits.

With investor psyche taking some hits right now, why don't we review some of the positive developments that could help the markets recover in the second half of the year. Interest rates are near historic lows. Thirty year mortgage rates recently fell to recorded lows at 4.58%. The affordability index for home purchases is at its highest level since the mid-1980s. U.S. corporate credit rating upgrades will exceed downgrades this quarter for the first time since the credit crisis hit. The index of Leading Economic Indicators has increased 13 out of the last 14 months, suggesting the economic recovery is on track. The primary indicator that is causing doubts about the recovery is the unemployment rate which remains stuck over 9.5%. Companies are reluctant to hire new employees until they have more confidence in the strength of the recovery and less uncertainty about new costs and regulations coming from government.

The havoc caused by the bond vigilantes in Europe lead us to believe that the era of ever increasing growth in government may be coming to an end. Fiscal discipline will be required by the financial markets. The austerity programs that are being adopted in Europe will be phased in over the next few years, so they should not cause a sharp drop in near term activity. Can our government come up with ways to increase incentives to hire and grow the private sector while limiting the growth of government expenditures? We don't have to reinvent the wheel. Tax reform and increasing incentives for private sector investment have worked in the past. Putting the economy back on a growth track similar to the last twenty years will lead to substantial increases in government tax revenues, closing the fiscal deficit if spending can be restrained. This would be a major boost to investor confidence and long term corporate profitability.

Another positive development that has not had much short term impact yet was the decision by the Chinese government to allow their currency, the yuan, to appreciate versus the dollar. The benefits for the Chinese include less inflationary pressure since most commodities are priced in dollars, greater purchasing power for the Chinese consumer, and less need for the Chinese government to accumulate dollar reserves that have to be invested back into Treasuries. A relatively weaker dollar versus the yuan will make our exports more competitive giving a boost to our manufacturing sector, make Chinese imports more expensive - which encourages saving over consumption, and it reduces our dependence on Chinese investment to offset the trade deficit. Let us stress that we are not in favor of managing currency values to promote trade advantages. We strongly support the idea that central banks should promote currency stability to make decisions on trade more certain.

In this environment, investors are looking for safety and yield. Unfortunately, it is not easy to find both in the same investment. Treasury bond yields are miniscule. High quality tax exempt

bond yields are very low. You have to take some risk to generate higher yields. By keeping the Fed funds rate at 0.25%, the Federal Reserve is pushing investors to take on risk. The last eight weeks have seen investors doing the opposite of what the Fed desires. At some point the anxiety that investors have now will dissipate and their need for higher yields will return. Stocks will benefit from that move as we are seeing some of the cheapest equity valuations in our memory. We cannot predict when it will occur, but we are confident that the bargains available now will not remain that way. In the meantime, our bond portfolios and our high yield convertible securities will generate cash flow and protect your portfolios. Here is how our various asset classes performed last quarter.

Blue Chip Strategy: The large company stock portfolio fell 9.21% in the second quarter versus a drop of 11.45% for the S&P 500 Index. For the first six months of the year, the Blue Chips are down 5.04% versus a drop of 6.66% for the S&P 500. The strongest performing position in the portfolio during the quarter was McDonalds, which was only down 0.45%. Alcoa was the weakest position, falling 29.17%. The second quarter was the weakest quarter for the market since the fourth quarter of 2008. With the “flash crash” on May 6th shaking investor confidence, the market correction ensued. The Blue Chips of the Dow Jones Industrials are trading at a trailing price-to-earnings multiple of 13 and an estimated P/E of 11. With fiscal and monetary policy extremely stimulative, we think valuations are incredibly cheap. We expect continued growth in corporate earnings and our Blue Chips have lots of cash available for acquisitions. Once BP is able to cap their well blow out or complete a relief well, we expect the negative publicity that has hurt the energy sector to diminish and give a boost to overall investor confidence.

Small Cap Value Strategy: Our small company stock strategy fell 11.56% in the second quarter and is down 6.64% for the first half of 2010 versus a drop of 9.92% for the Russell 2000 Index in the second quarter and a decline of 1.95% for the year to date period. Sometimes we consider renaming our portfolio the “Rodney Dangerfield” portfolio because many of our stocks don’t get any respect. Iridium Communications trades at 3.5 times cash flow. Winn Dixie trades at an enterprise value to EBITDA multiple of 2.5 times. Genco Shipping is the cheapest dry bulk shipping stock and recently announced a purchase of 13 ships, increasing their fleet by over 30%. Another recent portfolio purchase, Spartan Motors, trades at four times normalized earnings. Our weakest position during the quarter was Imperial Sugar, which fell 34% after a disappointing earnings report and weaker than expected processing margins. Our best performing position in the strategy was Dollar Thrifty Automotive, once again. We sold our remaining position in Dollar Thrifty last quarter as they announced an agreement to be acquired by Hertz and traded at a nice premium to the deal price. We used the proceeds from Dollar Thrifty and Brown Shoe to purchase six new positions this quarter including Crosstex Energy, Iridium Communications, Kimball International, Southwest Bancorp, Spartan Motors, and Susquehanna Bancshares. Research summaries are enclosed for all clients who have an allocation to the small cap strategy.

High Yield Convertible Securities Strategy: The high yield convertible portfolio fell 1.03% in the second quarter, but it is up 7.25% in the first half of 2010. For comparison, the Merrill Lynch Convertible Index fell 5.35% in the second quarter and 0.34% for the first six months while the Merrill Lynch High Yield Index declined 0.01% in the second quarter and is up 4.83% year-to-date. The best performing convertible bond position during the quarter was St. Mary Land and Exploration, rising 8.65%. Our KV Pharmaceutical bonds continue to struggle as the company sells assets to raise cash and continue operations until they can receive approval from the FDA to restart pro-

duction. One of our recent purchases, Global Industries, was impacted by the BP Gulf of Mexico well disaster. Global provides pipeline and offshore platform construction and support services in the Gulf of Mexico and around the world. We added two positions in convertible preferreds during the quarter: Omnicare provides geriatric pharmaceutical services to assisted living centers, nursing facilities, and hospitals; and Bank of America should benefit from their acquisitions of Merrill Lynch and Countrywide when the economy fully recovers. We sold half of our position in YRC Worldwide that recovered our original investment. We plan to keep the remainder to see if the company can survive. If they can return to profitability, we could see an impressive gain. Our master limited partnerships added to their gains in the second quarter and we expect distribution growth will resume this year. Ford Motor reported this week that they were repaying approximately \$4 billion in debt and would reinstate the dividend on their convertible preferred stock, which many client accounts own. The preferred stock was “cumulative” so the first dividend payment will catch up all the suspended quarterly dividends totaling over \$5.00 per share of preferred stock. We have numerous positions that will mature soon or may reach our price targets when the market recovers, so there will be more new names in the portfolio in the second half of the year. This portion of your portfolio generates attractive cash flow yields while we wait for market psychology to improve.

Intermediate Bonds: The Intermediate Taxable Bond Portfolio rose 1.64% for the quarter, and is now up 3.53% year-to-date. The Citigroup 1-10 Year Government/Corporate Index climbed 3.00% in the second quarter and has gained 4.60% year-to-date. Our tax-exempt strategy gained 1.51% in the second quarter while the Merrill Lynch 3-7 Year Insured Bond Index gained 1.75%. Our tax-exempt bonds have now risen 1.94% year-to-date, while the index is up 2.41%.

Our intermediate taxable bonds lagged the index as a result of two tactical choices we’ve made for our portfolio: “underweighting” U.S. Treasury bonds and maintaining lower portfolio duration (duration measures market value sensitivity to interest rate changes). Throughout the market turmoil in May and June, investors sold stocks and sought the safety of bonds. As a result, interest rates fell and bond prices rose.

Our portfolio’s lower duration meant that the market value of our bonds rose as rates fell but not by as much as the higher duration index. Our smaller exposure to Treasury bonds also dragged on performance as U.S. government debt outperformed corporate bonds 4.72% versus 3.26% in the second quarter based on Merrill Lynch indices.

We continue to believe that our decision to take less interest rate risk and more credit risk is the correct tactical approach for the foreseeable future. The yield on the U.S. Treasury Master Index is now 1.78% (the corporate index is 4.33%). As long as our economy avoids a deflationary trap, Treasury yields must move higher. When that happens, those “risk-averse” investors that have been buying intermediate and longer term Treasuries as an alternative to stocks will experience potentially painful market value declines.

We also continue to add value to our clients’ bond portfolios through security selection and by taking advantage of attractive swap opportunities. For example, this quarter we sold one Jefferies Group (an investment bank) bond held in many client accounts and used to proceeds to buy another Jefferies bond that was almost identical in terms of yield and interest rate risk, but our

new bond has an option to convert to common stock if the company goes up in value. We only gave up 0.15% in yield in exchange for this valuable seven year equity option. - J.P. Szafranski

The stock price volatility during the second quarter reinforces the impact that computer driven trading has on the markets. We strongly support free markets as long as the playing field is level. We are concerned that the proliferation of computer driven trading has tilted the playing field in favor of the players with the fastest, most powerful computers, and away from the individual investor. The “flash crash” of May 6th is another instance of an event that should never happen in orderly markets. Statistical analysis suggests that Black Monday in October, 1987 should never have happened. The Long Term Capital Management debacle in 1998 should not have occurred statistically. At what point does the speed of trade execution combined with leverage become too much risk for the financial system? Regulators need to address this issue along with the reform of derivatives trading. Investors remember the acute pain of the 2007-2009 bear market. Recent events have shaken investor confidence, resulting in very inexpensive stock valuations. We plan to take advantage of the cheap prices while they last. Eventually regulators and policy makers will address investor concerns and confidence will return. We plan to profit from it.