

Market Overview | Bad news dominated the headlines in the second quarter, beginning with the tragic explosion onboard the Deepwater Horizon oil rig in the Gulf of Mexico. The news culminated in a late-June release that reported a 30 percent plunge in pending home sales for May. In between, there was the debt crisis in Greece coming to a head, an attempt by Congress to revamp the U.S. financial system, an economic slowdown in China, weakening automobile sales and a fall-off in consumer confidence. Rather than climb this “wall of worry,” as the stock market historically has done, the S&P 500 Index gave back a little more than a third of the bull-market move it had made from early March 2009 to the recent high in mid-April. Throughout the quarter, estimates of 2011 S&P 500 earnings increased and then decreased to end slightly below where they began. The market was selling at 11.4 times earnings at quarter-end using those 2011 estimates. Volatility in the market spiked in May and continues at an elevated rate.

The market reached a peak in late April, but plummeted from there by nearly 15.0 percent to the end of the quarter. S&P 500 stocks with high beta generally underperformed stocks with medium and low beta. Lower-quality stocks underperformed but only modestly. Dividend-payers with a yield above the S&P 500 at the beginning of the quarter outperformed those that had a yield below the S&P; however, non-payers also outperformed that latter group.

Portfolio Review | Equity Income portfolios outperformed the benchmark S&P 500 Index for the quarter. Just less than half the outperformance came from sector allocation with the strategy’s modest cash percentage, overweight in telecommunications and zero-weight in technology leading the way. The remainder of outperformance came from stock selection, particularly within the consumer staples, financials and industrials sectors. The only stocks that detracted significantly from relative performance were BP and Regal Entertainment.

In such a negative market environment, only four Equity Income stock picks posted a positive absolute return. They were AvalonBay Communities, US Bancorp, HCP and General Mills. The five worst-performing stocks were BP, Regal Entertainment Group, Emerson Electric, Home Depot and ExxonMobil.

Outlook | The economic outlook has clearly taken a step back from the encouraging signs we witnessed last quarter. The question of the day now seemingly is, Will we have a double-dip recession? There are plenty of economists and TV talking heads who are predicting another slide into crisis territory. The good news may be that economists, strategists and TV personalities with books to sell have dismal records as fortune-tellers. We continue to believe that we are in a slow-growth environment and that it will take an extended amount time to fix the structural problems in our economy.

We are confident of our companies’ ability to thrive in the coming economic environment. Despite a less-than-robust worldwide economy, many of our companies are reporting record cash flows and improved profit margins; they have more than adequate access to capital; and a renewed focus on their businesses. Several companies have reinstated dividend increases after holding payouts flat for an extended period. In addition, many companies have raised their dividends more than once over the past year. We believe our strategy of owning high-quality, dividend-paying companies with solid growth prospects will continue to excel in the current economic environment.

The risks associated with Equity Income investing are based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions.

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Separately Managed Accounts:

Equity Income

Representative Holdings

General Mills

3M

Emerson Electric

Johnson & Johnson

Procter & Gamble

Sysco

Abbott Laboratories

PepsiCo

ExxonMobil

Home Depot

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