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Managing Director  
and Portfolio Co-manager

**David Blount, CPA, CFA**

Portfolio Co-manager

**John Pandtke, CFA**

Portfolio Co-manager

**Separately Managed  
Accounts:**

Value

All Cap Value

**Representative Holdings**

Occidental Petroleum

Bank of America

Halliburton

Pride International

American Express

JPMorgan Chase

International Business  
Machines

Union Pacific

Home Depot

Ameriprise Financial

The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data is shown for informational purposes only and is not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice.

**Market Overview** | The stock market continued its dramatic rally off the March 2009 lows until late April, when a confluence of concerns resulted in the first significant correction in the market in more than a year. Beginning with the BP oil spill, the market's focus turned to the sovereign-debt crisis in Europe; worry about a major economic slowdown in China; the prospect for onerous U.S. financial-system reform; and, most recently, continuing weak employment statistics raising the specter of a "double-dip" recession. As a result, most major stock-market indices registered double-digit declines in the second quarter.

**Portfolio Review** | Value portfolios underperformed the benchmark Russell 1000 Value Index mainly as a result of our positioning in the energy and financial sectors despite some strong performance among our industrial holdings. We had significant exposure to companies directly or indirectly implicated in the explosion and aftermath of the Deepwater Horizon drilling rig. We sold our position in BP as it became clear to us that politics and the legal system – not valuation and business trends – would determine the fate of the company and its stock. We have retained our positions in Halliburton and Transocean because we believe the focus is now much more on BP's transgressions, as operator of the project, and not those of its contractors. Our underperformance in the financial sector is largely explained by weakness in capital markets-focused companies, such as Ameriprise, Morgan Stanley and Lazard. Financial-reform legislation is not yet complete but many of the most damaging proposals have been removed and we continue to believe that these stocks offer very good value.

Our All Cap Value portfolios also lagged their benchmark, the Russell 3000 Value Index, this quarter. They faced many of the same challenges as Value portfolios; additionally, some of the smaller-capitalization stocks that had been stalwarts of All Cap Value's strong returns over the past year succumbed to profit-taking. Three of our weaker-performing, smaller-capitalization companies were Smithfield Foods, Carmike Cinemas and Mylan Labs.

**Outlook** | There seems to be something about the 12- to 15-month period after an economic recovery has begun. Historically, that's when fears of a relapse into recession begin to surface. The "double-dip" recession is like a mythical monster: It is always feared but never seen. There are no examples in modern financial history of an economic recovery relapsing into recession so soon. The pace of recovery always slows as "recovery" becomes "expansion" and that is what we believe we are seeing now. It is not impossible that some event could collapse consumer demand and recession would return but given historical precedents and current strength in the manufacturing sector, this – in our view – is a low-odds outcome.

The relative and absolute valuation of equities is very attractive to us at current levels and the current market weakness is, in our view, creating many bargains for long-term investors. We believe the S&P 500 companies will earn around \$80 this year and close to \$90 in 2011. On that basis, the S&P 500 is selling at less than 12 times next year's earnings: the cheapest price-to-earnings ratio on forward earnings the market since 1995. Many high-quality stocks are selling at single-digit multiples beneath the surface of the market averages. Corporate America, in our view, has never been in better financial condition: cash on balance sheets is at an all-time high, free-cash-flow yields are more than 7 percent on average and the earnings outlook is solid.

High-quality U.S. stocks – unlike residential and commercial real estate, commodities, private equity, mortgage-backed securities and currently, Treasury bonds – are the only asset class that has not been inflated this decade. In 1998, the S&P 500 earned about \$45 per share. Today, the market is at about the same level it was in 1998 but earns nearly twice as much. That is not characteristic of an inflated asset class. It is cheaper for many companies to "buy" rather than to "build," which we believe will lead to a resurgence in merger-and-acquisition activity. Finally, investors have trillions of dollars earning no interest (no return) on cash and cash-like instruments. We believe a good part of that cash hoard will eventually find its way into equities.

*Value investing is based on the potential for a company's stock price to rise based upon anticipated changes in the market or within the company itself. Value stocks have historically been sensitive to economic cycles and investor sentiment that can affect volatility and risk.*