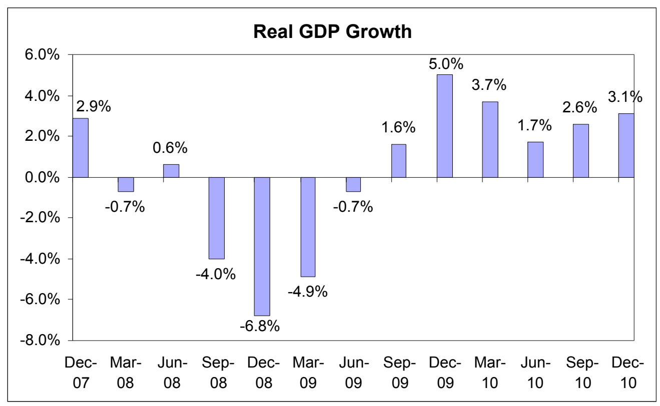
Investment Update
First Quarter 2011

The Economy

The most recent quarter was marked by an unprecedented confluence of so-called "Black Swan" events. The uprisings in numerous Middle-Eastern countries and a third US military initiative, as well as the Japanese earthquake and resulting tsunami and nuclear crisis were totally unexpected events with potentially far-reaching and negative consequences. Other unsettling and related developments include higher energy prices, in particular for gasoline, the possibility of a fiscal crisis that could shut down certain federal government operations, and the continuing sovereign debt crisis of several European economies.



Despite this menu of uncertainties our economy and financial markets have risen, and optimism for the future seems to be gaining strength. So far this year the Dow Jones Industrials advanced 6.4% and the S & P 500 was ahead 5.4%, the best first-quarter moves in over ten years. What accounts for this performance? We agree that the economic outlook is favorable. Most recently 2010's final quarter of GDP growth was revised upward to 3.1% year-over-year. Monetary and fiscal policies are aggressively stimulative although the sustainability of these actions is open to question. The Federal Reserve continues to expand bank credit by means of QE2, but this policy will expire at mid-year. Inflation risk along with growing political opposition is likely to end QE2 on schedule. We still expect the Fed to maintain the Federal funds rate at close to zero through the end of the year.

The fiscal situation is more difficult to analyze. The adoption of successive short duration budgets by Congress has delayed many of the necessary difficult decisions. It seems clear that major changes in spending priorities and absolute levels are required, but the issue is intertwined with political considerations. Political deadlock and a federal government shutdown are real possibilities.

The conflict in Wisconsin and the sovereign debt crisis in Europe are symptoms of the same disorder. The growth of government spending in many world areas has proceeded at a rate that cannot be supported by current tax rates and reasonable growth expectations. To put this in perspective consider that more Americans work for

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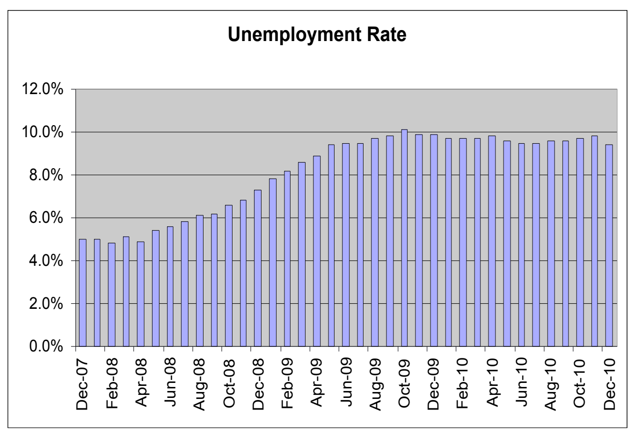
government than work in construction, farming, fishing, forestry, manufacturing, mining, and utilities combined. The use of debt for financing fiscal deficits depends on the cooperation of lenders, which range from domestic investors to balance-of-payments surplus countries such as China, Japan, and Middle East petroleum exporters. The most promising approach is the curtailment and reduction of spending along with selective tax increases. The challenge will be to design tax increases that will not limit growth prospects. There are no easy solutions, but it should be clear to all that continued government expansion financed by increasing debt and higher taxes is no longer a viable model. In the case of our domestic government, debt as a percentage of GDP has increased from 31.4% in 1980 to 42.2 % in 2009, and the percentage has increased substantially since that date. This trend is not sustainable. Leadership to deal with the issue is vital.

Consumer confidence has generally been firm despite periodic setbacks from unexpected events such as those experienced in the first quarter. Of interest is the consumer's reduction of debt. This, along with rising personal income and the ongoing write-off of toxic mortgages has sustained consumer spending at reasonable levels. The major problem area is the housing industry where prices continue to be weak, foreclosures mount, and resale inventories are excessive. While some signs of stability are evident, it is likely to be at least another year before prices pick up and new construction shows any meaningful recovery.



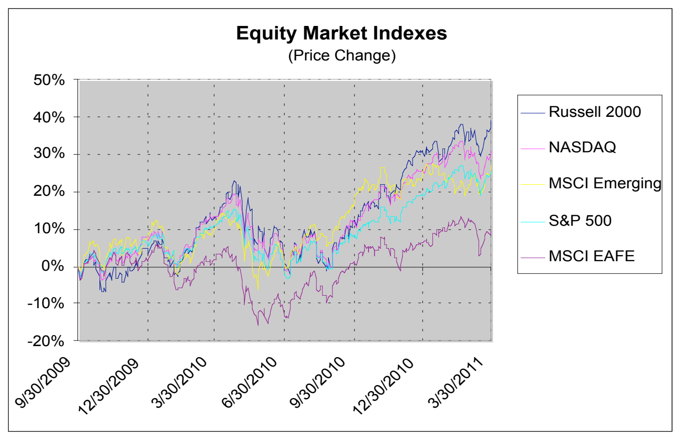
Despite positive trends in many areas, unemployment persists at high levels, currently 8.8%. This is a modest improvement from the extreme levels of close to 10% a few months ago. Regardless, these figures are unacceptable for a variety of reasons and have occurred despite aggressive government fiscal and monetary policies. In this respect the current economic recovery from 2008 has been the weakest in the post World War II era. Still, GDP growth is likely to continue at about a 3% rate year over year for the balance of 2011. The risk of a renewed recession appears very slim. Corporate profits are forecast to gain 10% or more this year in comparison with the previous year, helped by export sales growth and strong productivity trends.

The absence of more typical job growth in this recovery is attributable to the private sector and in particular the lackluster trend of investment spending. While many explanations have been offered, a major factor appears to be risk aversion. Corporate managements, shocked by the near-death experience in 2008-2009, have consciously elected to curtail investment spending and the attendant hiring of new employees. This is despite ample liquid resources, with cash on US corporate balance sheets estimated to be at record levels of almost $ 2 trillion. A substantial part of this is held overseas since domestic remittance would require payment of US taxes that are deemed to be unacceptable. Changes in tax laws are being considered, and, recently we note a bipartisan interest in lowering corporate rates. Also, questions regarding health care costs, a continuing stream of anti-business rhetoric from some government officers, and heavy-handed regulation has not been helpful.

Clearly, a change of corporate attitudes regarding investment spending could be highly beneficial since it is only the private sector that can create meaningful job growth. Greater corporate investment will result in a pick up in hiring and stimulate growth, which in turn will generate increased tax revenues to help alleviate the fiscal problems. Ultimately, this scenario may have a more favorable impact on unemployment and our economic performance than the continued application of the current fiscal and monetary policies. A reemphasis on the importance of incentives and the profit motive could be a powerful force for dealing with many of the problem areas discussed. We are encouraged that some evidence is available to support a rethinking of these issues.

Equity Markets

The equity markets have performed well despite the uncertainty of recent events. Corporate profits have continued to exceed expectations so that valuations in domestic and overseas markets are generally reasonable. Further, modest returns from other asset categories are encouraging investors to assume more equity risk. Overseas markets have also been steady despite concerns over more restrictive government policies in China and higher raw material costs that are constricting margins. The importance of diversification across asset classes should be stressed. We continue to note that the strongest economic growth is in the emerging markets where valuations are still attractive. In the absence of any additional “Black Swan” events we are optimistic that stock prices can advance further over the balance of the year.



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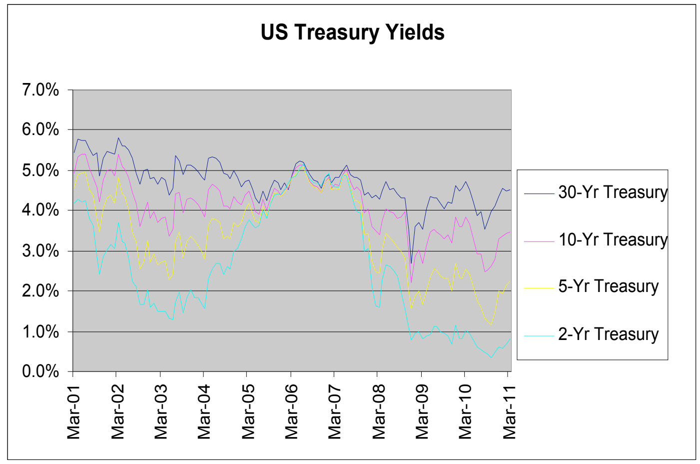
Fixed Income Markets

Inflation is always a major concern for the fixed income markets. Core price increases appear to be under control, but trends for food and fuel are worrisome. The huge amounts of liquidity that have been injected into the system by the Fed may have rescued the economy from an even more serious contraction, but it represents the raw material of future inflation. It will be the Fed's challenge to withdraw this liquidity as the economy strengthens in order to contain inflation pressures. This will require an exquisite sense of timing and judgment.



The near term outlook for inflation, defined as the current year, looks manageable but longer term the risk increases. For this reason we remain cautious about investing in longer maturity securities and prefer to construct bond portfolios by means of strict duration management, insistence on quality, and regularly scheduled maturities to take advantage of reinvestment opportunities.