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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

A foundation of Modern Portfolio Theory is that markets are efficient in pricing securities to reflect all available information. **We agree that the most efficient mechanism for pricing securities fairly is a transparent market where information is available to a large number of participants with different goals and investment horizons.**

But Modern Portfolio Theory further assumes that investors evaluate this information rationally. **The recognition that investors are human and that human beings are subject to emotional as well as rational behavior has given rise to a discipline called "behavioral finance"**.

Why are we talking about these academic theories? The answer is really quite simple. After last year's rapid rise in the stock market, **we felt that the broad market, a leading indicator of economic activity, would begin to reflect investor uncertainty over the speed of the recovery.**

That it has, in ways far more dramatic than we had anticipated. **While we have no intention of trivializing the impact of the Greek sovereign debt issue on the Euro, or the environmental and economic damage done by the BP disaster, they are both eclipsed by the sheer magnitude of the global economy**. Both of these events, however, had an impact on the market far beyond their immediate economic impact. In both cases, the market impact was, and still is, exaggerated by the uncertainty of their ultimate resolution.

In a somewhat less dramatic, but no less significant example, the same can be said of reform legislation, both passed and pending, in this country. With the health reform bill's passage months ago, significant details remained to be worked out. **Currently about seventy percent of the provisions have been defined and valuations in the health care sector are beginning to move toward equilibrium levels.**

The same is true of the financial reform legislation. When agreement was reached on a final bill, financial stocks rallied in spite of almost universal disappointment over the compromised structural provisions. **While much of the final impact on the companies which comprise the sector was left to be determined by regulators, the stocks rallied because a cloud of uncertainty was partially lifted and companies, and investors, were again able to plan for the future.**

As we write this article, we are still days away from the second quarter earnings reports. When these reports are delivered to investors, they should provide greater visibility to future economic trends. Since March, profit estimates for companies in the Standard and Poor's 500 Index, have climbed 5.1 percentage points, for an increase of 33.7 percent, according to data compiled by Bloomberg. These increases in estimates are the strongest for any quarter since 2004. **Combined with increases in corporate spending, a modest improvement in hiring and companies' expression of optimism about their prospects for the second half, this could be the catalyst for stronger market performance.**

The equity portfolios we have constructed are biased toward continued economic recovery. Year to date, we have been buffeted by a surprising amount of emotion driven volatility. **Perhaps, in the weeks ahead, reason will begin to prevail over emotion**.

Fixed Income Market

In the recent two-day Federal Open Market Committee (FOMC) meeting, the Fed left rates unchanged. Futures now indicate a 74 percent chance that the Fed will maintain current interest rates through its December 2010 meeting. This has helped the U.S. credit markets maintain borrowing costs at relatively low levels, on a historical basis, even with the recent slight increase due to the European contagion. Additionally, U.S. corporations continue to maintain a relatively high confidence level in the domestic recovery process. A May survey of chief financial officers by the ISI group showed that U.S. companies intended to spend more on capital expenditures and hiring in 2010 than they had planned only six months ago. To facilitate this spending, according to the Federal Reserve Board, corporate America had the highest level of cash on hand since 1952, at the end of the first quarter. **This data supports the continued strength of domestic companies and their debt offerings. Nevertheless with higher rates on the horizon, we continue to limit our duration to the intermediate term and focus on high quality issuers in the arena of corporate debt.**

With regard to municipal offerings, despite some of the highest household ownership levels in history, headline news has focused on the fiscal weakness of state and local municipalities. By example, a local city south of Los Angeles called Maywood recently laid off all its employees, disbanded its police department and contracted its operations to the Sheriff's department and neighboring city of Bell. **Although widespread defaults are not expected, this case highlights the importance of careful diligence in bond offering reviews and diversification of holdings.** One area we have seen some opportunity is with taxable municipal offerings with slightly longer maturities. These offerings from highly rated municipalities do not offer the traditional tax free benefits, but have relatively higher yields when compared to equally rated corporate offerings.

Finally, on the international front we have seen China announce its intention to allow the Yuan to appreciate versus the dollar. **This revaluation should allow for improvements in the trade balance between the two countries and facilitate increased investment by China domestically and abroad as its $2 trillion currency reserve is freed up**. The question remains however, how much China will allow the Yuan to revalue and the timing of the revaluation. We will continue to monitor the impact of any movements by China and the potential impact on US interest rates.

International Market

The second quarter of 2010 marked the beginning of the Soccer World Cup, arguably the world's most widely watched sporting event. As matches enter the final rounds, the excitement of the game has brought a large part of the world into a soccer celebration. However, we see a polar opposite scene on the streets of Athens. **The overturned vehicles, burning buildings, and police in riot gear send out a self-destructive message to the rest of the world that Greece, a country with 17 percent of its GDP coming from tourism revenue, is out of control**. As more protestors march in the streets across major cities of Greece, the more the country's ability to implement painful austerity measures such as cutting pensions and salaries and raising consumer taxes comes into doubt. If these budget requirements for receiving emergency loan funds from the European Union and the International Monetary fund are not met, what would be the fate for Greece? Would the country, like their national soccer team that took an early exit from the World Cup, be the first member to bow out of euro zone? And, more importantly what would this do to the destiny of the euro as a common currency?

Although we continue to monitor all world events, we review the situation in the Euro region due to the recent abundance of headline news and negative impact on the stock market. **Consensus is that in order to restore investor confidence in the region and to ensure sustainable economic growth, some form of fiscal restraint is essential**. Thus, trying to avoid another round of recession, European governments have now embarked on a tough round of budget cutting on top of the euro 1 trillion pledged by the European Union as a safety net to backstop the euro.

Early signs of success are beginning to be seen; concerns that nations within the region will have trouble financing themselves have been tempered a bit as evidenced by the recent successful bond sale by Spain. This "PIIGS" nation sold euro 3 billion of 10-year debt on June 17 at a 4.864 percent yield. The yield on this offering was below the 5.040 percent that similar maturity bonds traded at on the secondary market due to interested bids on the bonds coming in at almost twice the amount being offered. Also, with the help of a depreciated euro, making European products more competitive on the international markets, the European Central Bank raised its euro zone growth forecast for this year to 1 percent.

That said, we do not see the current measures being implemented as a long-term solution to the fundamental and structural issue of using a single monetary policy to serve a group of member nations, each with its own set of fiscal policies. In order for the common currency to work, a requisite for all member nations to keep their fiscal policies bound by an agreed range should be enforced. **What led to the current euro zone predicament is the lack of an enforcement mechanism to keep countries such as Greece in check and current solutions still have not addressed this enforcement issue.** Ultimately, after all the dust settles the governments of those euro zone countries that spent their taxpayers' money to rescue those countries that lacked fiscal discipline will need to answer to their own citizens. They will need to convince their voters that future crisis can be avoided with the installation of an enforcement system with real authority. Otherwise, they will have no choice but to take the next alternative, a reversion of the European community to the pre-euro days. Solvency risks will then again be isolated to a specific country rather than affecting the whole region.