

**REVIEW**

During the second quarter, investors enjoyed a much-welcomed recovery from the past year’s disastrous investment markets as global equity indices rebounded significantly from the lows of March 9, 2009. The Standard & Poor’s 500 Index climbed 15.9%, the Dow Jones Industrials were up 12%, and international equities surged 25.6% during the quarter. In addition to the nice bounce in equity prices, credit spreads improved for most corporate, asset-backed and mortgage-backed securities. In the past week or two the government dropped a couple of the rescue programs announced earlier—a small sign that things are improving.

<b>2009 2nd QUARTER RETURNS</b>	<b>Q2 2009</b>	<b>YTD 2009</b>
Standard & Poor’s 500 Index	15.93	3.16
Dow Jones Industrial Average Index	11.96	-2.01
NASDAQ Index	20.34	16.98
MSCI EAFE (intl. equity) Index	25.64	16.99
Barclay Intermediate Government/Credit Index	1.67	1.62

**RESETTING EXPECTATIONS**

Some have referred to the current economic cycle as the “Great Recession,” the worst economic climate since the Great Depression. In past decades we have been through periods of difficult economic conditions, experienced recovery, and continued to grow. The severity of the current economic recession may cause corporations, consumers and governments to permanently “reset” or “adjust” their expectations.

We are in the midst of massive governmental intervention like we have never seen, even during the 1930s. President Obama’s administration, aided by support from the Democrat controlled Congress, is dramatically expanding the role of government in ways no one would have forecast a year ago. The aggressive nature of these actions is illustrated by the onerous terms of the General Motors and Chrysler bankruptcies. The government is modifying, it seems, just about every social or economic program, especially in the area of financial markets. It is impossible to know whether these activist interventions will continue or be scaled back after a recovery. However, if history tells us anything, it is that government programs, once enacted, seldom disappear. A substantial amount of the increased regulation and oversight of the financial markets, in particular, is likely to be permanent. Changes in healthcare, energy and the environmental regulations are also top priorities for the federal government. These programs will carry huge price tags and require a surge in debt issuance that is unprecedented even during wartime. The possibility of trillion dollar deficits is quickly becoming a reality and may exist for years to come. In the fiscal year ending September 2009, the government is expected to run a budget deficit four times as large as 2008 and the largest dollar deficit in our history. The current entitlements of Medicare/Medicaid and Social Security, which combined represent an estimated \$75 trillion liability over the next 50 years, threaten to take the country to a seemingly unsustainable debt level. This means even bigger government, more regulation and larger liabilities.

*Continued on Reverse*

Many industries have seen revenues decline as much as 50%, making it difficult to operate. Businesses know how to cut expenses, but the impact of that cost-cutting materialized in the form of extremely high unemployment. Corporations will likely clean up their balance sheets, reducing their debt load and raising more equity. Not all businesses will avoid bankruptcy but many will survive and become stronger. Corporations will adapt by becoming leaner and better managed.

Individuals and families seem to have endured the most pain in this environment. Lost homes and careers are taking a tremendous human toll. Even if you have not been directly impacted, you probably have a friend or family member who has lost either their job or some of their income. The soaring unemployment and housing foreclosure rates mean the “American Dream” may be put on hold for many of us. It is doubtful that easy credit and the free-flowing economy of the 80’s and 90’s will return soon. But the traditional idea of living within your means is making a comeback, with the savings rate already rising to the highest level in 15 years. Credit card use is down and debit card use is up. Even though many banks have money to lend, demand for credit is weak.

Individuals have an internal drive to survive, thrive and the ability to adjust. It is during challenging times when great innovation often occurs out of necessity. New ways of thinking and doing thrive. We will need this innovation and drive to restore our way of life and our economy in the coming years. The result may be more fiscally conservative lifestyles with less emphasis on material goods.

## OUTLOOK

**I**t seems we have passed the crisis stage of this economic cycle, but we definitely do not intend to add large amounts of risk to our clients' portfolios. Most portfolios have been underweight in equities, and that conservatism served our clients well in 2008 and early 2009. We have been dollar-cost-averaging into the equity markets over the past three months, emphasizing large-cap growth and international equities, but still remain below targeted equity weightings. The international funds we use performed particularly well during the quarter, while our large-cap holdings slightly underperformed due to a lower than market weighting in financials. In some of our accounts that hold only mutual funds, the increased weighting in equities was achieved by virtue of the fund managers' use of internal cash to add to their equity holdings. While financials did very well during the past quarter, we believe the banking sector will face challenges going forward due to the regulatory and consumer environment discussed above. We will continue to employ this strategy of incrementally increasing equity exposure in portfolios where such action is consistent with the individual goals of our clients.

In the selection of fixed income securities, we continue to focus on high credit quality securities. We have added to the corporate credit market versus government securities based on the large pick-up in yield and the opportunity for credit risk to decline as the economy stabilizes. We have been aggressive buyers in the municipal bond market as well for most of the quarter, but as yields have fallen with the higher prices of municipal bonds they became less attractive. Again, we are focusing on high quality general obligations and essential utility bonds.

As always we are looking long-term and see an end to these very challenging times and a more prosperous period in the future. Thank you for allowing us the opportunity to be a trusted advisor for you.

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