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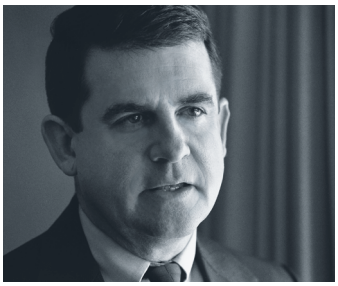
What's Ahead in 2011

An Investment Perspective: Summer Update

- **The Economic Backdrop:** The economy has entered a soft patch, but this should be a temporary condition. *See page 2.*
- **Six Reasons for Optimism:** We expect conditions will improve in the second half of 2011. *See page 2.*
- **An Update on Our "10 Predictions for 2011:"** At the halfway point of the year, most of our predictions are on track. *See page 4.*
- **The Outlook:** We maintain our view that stocks will outperform cash and bonds. *See page 6.*
- **Investment Opportunities:** We recommend overweight positions in equities, continue to favor US stocks, believe growth styles are increasingly attractive and encourage investors to remain highly selective. *See page 7.*



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The Economic and Market Backdrop

The soft patch in economic data is real and the pace of economic acceleration has slowed to less than it was last year.

Despite the current slowdown in growth, we believe there are reasons to be optimistic and do not believe another recession is in the cards.

A "Soft Patch" for the Economy

The second quarter of 2011 began much the same way that the first quarter ended: Confidence levels were improving, the economy was recovering and investors were moving back into equity markets at a sustained pace. That backdrop changed markedly in May and June, however, as concerns grew about rising oil prices, escalating problems related to the European sovereign debt crisis and, above all, a weaker tone to economic growth.

In our opinion, some of the weakness in US economic data that occurred over the past couple of months can be attributed to temporary factors. The oil price spike has already receded somewhat and data was also depressed by such factors as flooding in the Southern United States and the impact of the natural disasters in Japan that occurred in March. In any case, the soft patch in economic data is real and the pace of growth has slowed to less than it was last year.

In many ways, the current slowdown should not come as a surprise. Typically, economic recoveries that occur after a financial crisis tend to be uneven (indeed, we saw a similar soft patch last summer) and the current recovery has not been an exception. Current data suggests that US gross domestic product expanded at around a 2% rate in the first half of 2011. Normally, such a rate would not be all that bad, but when it occurs against a backdrop of significant unemployment, it feels much worse to many.

Six Reasons for Optimism

Despite the current slowdown in growth, we believe there are reasons to be optimistic and do not believe another recession is in the cards. In particular, we can identify six reasons to be optimistic about the future path of the economy and believe that economic growth will accelerate during the second half of 2011:

1. Gasoline prices have fallen noticeably in recent weeks (declining 30 cents from early May). This is particularly significant since gas prices typically rise during this time of year. Higher gas prices were one of the most-cited factors by households in recent months as a cause for economic distress, so any decline should not be overlooked as a source of optimism.
2. The disruption from the earthquake in Japan is now fading. The interruption in supply chains caused a significant downturn in US automobile production in the second quarter, but that downturn appears to be over.
3. Consumer deleveraging is slowing. Household debt levels are falling, bank lending is accelerating and credit standards are easing, all of which suggest that consumer spending is poised to pick up.

4. We believe there is significant pent-up demand in the economy. Outside of inventories, the other four cyclical components of the US economy (consumer durables, business equipment and software, commercial real estate and residential housing) remain well below their pre-recession highs and have room to climb.
5. We do not believe the fiscal problems affecting the country will act as a significant drag. Some spending cuts are likely to be implemented as Washington wrangles over the debt ceiling issue and broader deficit problems, but cuts will be spread out over a period of 10 years, which should lessen the impact.
6. Perhaps most importantly, the labor market is slowly recovering. Although unemployment remains high and the pace of jobs growth has been uneven, the outlook appears brighter. Initial unemployment claims are high, but falling, the number of hours worked has been rising and corporations are likely to accelerate hiring plans, all of which bodes well for future jobs growth.

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The Second Quarter by the Numbers

Stocks began the second quarter by moving higher in April before they experienced a long (but relatively shallow) correction for most of May and June as investors moved away from higher-risk assets in the face of growing uncertainty and weaker economic data. Thanks to a sharp rally that occurred as the quarter drew to a close, however, most markets actually posted positive gains for the quarter. In the United States, the Dow Jones Industrial Average was up 1.4% and is up 8.6% for the year. The S&P 500 Index climbed marginally during the quarter (up 0.1%) and is up 6.0% for the year. The Nasdaq Composite was flat for the quarter and is up 5.0% year-to-date. Small cap stocks (as represented by the Russell 2000 Index) lost some ground in the second quarter, falling 1.6%, but are still up 6.2% for the year.

Outside of the United States, results were mixed. Europe continues to be dominated by ongoing debt issues, which have hampered returns, but some markets (notably, Germany, which was up 4.7% for the quarter) have benefited as a more stable, safe-haven investment choice. Japanese stocks recovered from the downturn they experienced in the first quarter, and were up slightly at 0.7%. Emerging markets continued to underperform in the second quarter. Chinese stocks dropped 4.6% and emerging markets as a whole (as represented by the MSCI Emerging Markets Index) declined 1.2%.

In US bond markets, yields were volatile but generally moved lower as economic expectations softened. The yield on the 10-year Treasury fell from 3.45% to 3.16% at the end of the quarter. In this environment, the Barclays Capital US Aggregate Bond Index posted a quarterly gain of 2.3% and is up 2.7% for the year. Finally, cash investments, as represented by the 3-month Treasury bill, returned a minor fraction over 0% for the quarter, as short-term rates have been and remain very low.

10 Predictions for 2011: The Scorecard So Far

At the halfway point of the year, the majority of our predictions remain on track. Stock prices have been uneven, but year-to-date gains have been solid and the areas of the market we have preferred have been outperforming. Economic growth has slowed, but we remain optimistic that it will be strong enough to make most of our economy-oriented predictions correct by year's end.

1

US growth accelerates as US real GDP reaches a new all-time high.

We are likely to get the first half of this prediction wrong. 2010 GDP growth came in just under 3%, suggesting that the second half of 2011 would have to accelerate to close to 4% for 2011 growth to exceed 2010's. Although we are calling for improved growth over the next six months, such a pace is extremely unlikely. Despite the sluggish pace of growth, however, the US economy has grown enough to reach a new all-time high. In its final first-quarter GDP report, the Bureau of Economic Analysis indicated that real US GDP reached $15.02 trillion, the highest level on record.

2

The US economy creates 2 million to 3 million jobs in 2011 as unemployment falls to 9%.

Although employment data has been uneven so far this year, some significant jobs growth has occurred in the first half of the year and we are well on our way toward reaching the 2 to 3 million level by the end of the year. Unemployment remains painfully high and is hovering at over 9%, but that does represent an improvement from the beginning of the year and we anticipate that level will fall slightly by the end of 2011.

3

US stocks experience a third year of double-digit percentage returns for the first time in over a decade as corporate earnings reach a new all-time high.

Market volatility was high over the first six months of the year, but US stocks are up 6% for the first half of 2011. We will need to see continued price appreciation to reach the double-digit mark for the year. Corporate earnings have remained a bright spot for several years and have been growing strongly. Although the pace of growth may slacken over the coming quarters, earnings should reach a new all-time high in the third quarter of this year.

4

Stocks outperform bonds and cash.

We are, as of now, on the right side of this call. Although bonds rallied in the second quarter, stocks are still outperforming on a year-to-date basis, and as long as equities post any sort of positive returns, they should beat cash investments.

5

The US stock market outperforms the MSCI World Index.

So far, we are correct on this prediction, if only barely. The MSCI World Index is up 5.3% so far this year, slightly trailing US stocks. Looking ahead, we continue to believe that US stocks remain better positioned than their developed market counterparts and we expect this prediction will prove to be correct at the end of 2011.

6

The US, Germany and Brazil outperform Japan, Spain and China.

If the year ended today, this is another prediction we could mark in the "correct" category. At the halfway point of the year, the United States, Germany and Spain are in positive territory, whereas Brazil, Japan and China are showing negative results. As of now, a basket of our "outperform" countries has outperformed a basket of our "underperform" countries.

7

Commodities and emerging market currencies outperform the dollar, euro and yen.

Despite the significant correction that occurred in many commodities markets in the second quarter, commodities are still in positive territory for the year and have outperformed developed market currencies. Additionally, emerging market currencies have been stronger than developed market currencies to date, so this is another prediction that remains on track.

8

Strong balance sheets and free cash flow lead to significant increases in dividends, share buybacks, mergers and acquisitions (M&A) and business reinvestment.

Without question, this prediction has been coming true. Corporate dividends, buybacks and M&A activity are all up nicely for the year, factors that have been acting as a tailwind for stocks. Interestingly, M&A activity has been particularly shareholder friendly in 2011, given that, in many cases, when deal activity has been announced, not only has the to-be-acquired company seen a stock price boost, but so has the acquiring company.

9

Investor flows move from bond funds to equity funds.

As of now, it looks like we may get this call wrong. Investor flows moved into stocks during the first quarter of the year, but the second quarter saw a significant outflow of money from stocks back into bonds. This trend may reverse itself over the next six months, but for the year as a whole, it looks like we may be on the wrong side of this call.

10

The 2012 presidential campaign sees a plethora of Republican candidates while President Obama continues to move to the center.

For a variety of reasons, the GOP race got off to a slower-than-expected start this year, but over the past couple of months, the number of officially declared candidates has been climbing as the stage is being set for the primary season. On the Democratic side, President Obama has continued to maintain a relatively centrist position as he attempts to work out various compromises with Congress.

The Outlook

Looking ahead, the future performance of the equity markets will be largely dependent on whether or not the current soft patch in the economy is temporary. We think it is, meaning that we expect stock prices to move higher in the second half of the year.

The bottom line is that we believe investors should maintain a bullish bias, but should also be cognizant of the many risks that could negatively impact stocks. We continue to recommend that investors view periods of weakness as an opportunity to take on additional risk.

Coincident with the softer patch of economic data, conviction levels have been low among investors, which have caused stocks to trade in a sideways pattern for the last several months. Looking ahead, the future performance of the equity markets will be largely dependent on whether or not the current soft patch in the economy is temporary. As discussed earlier, we think it is, meaning that we expect stock prices to move higher in the second half of the year.

The downside to this view is that ours is the consensus opinion. Most observers expect economic growth to accelerate, meaning that there is ample downside risk for stocks if the economy falters. The bottom line is that we believe investors should maintain a bullish bias, but should also be cognizant of the many risks that could negatively impact stocks. We think the sovereign debt crisis should remain contained, but the possibility of a broader credit crisis is certainly one to be watched. There are also risks in the form of a potential hard landing for the Chinese economy, but we do not think that is likely. In the United States, we do expect economic data to turn more positive and we do not anticipate that US fiscal imbalances will result in a serious setback, but the news flow and data will remain uneven.

On balance, we believe the macro backdrop remains equity-friendly. The economy is still growing, inflation is low, monetary policy is easy and corporate earnings and profits are climbing. Given all of the uncertainty, we do expect investor anxiety and market volatility levels to remain elevated for the time being. At some point, however, we expect stock valuations will settle at a level where investors feel adequately compensated for the downside risks facing the market. Our constructive view toward the economy and the markets makes us suspect that such a valuation level is not too far away. As such, we continue to recommend that investors view periods of weakness as an opportunity to take on additional risk.

Opportunities for Investors

It is a difficult time for many investors, with a positive macro environment conflicting with a number of short-term risks. Our baseline view is that conditions are improving and that investors should consider taking on additional risk in their portfolios. As always, we encourage investors to work with their financial professionals to focus on their long-term objectives and to find tactical investment strategies that work within the context of their long-term plans.

- **Remain cautious, but move back into equities:** There are ample risks, but our view is that the macro and fundamental backdrop warrants overweight positions in stocks. We believe that stocks should outperform cash and Treasuries over the coming months and years.
- **Consider buying on weakness:** Market conditions are set to remain volatile and we should see continued back and forth in both the tone of economic data and in asset prices. For those investors with longer time horizons, it may make sense to view market setbacks as potential buying opportunities.
- **Focus on areas of strength:** Geographically, we continue to prefer US stocks over other developed markets. We also believe that emerging markets performance should improve over the second half of the year. From a sector perspective, we favor healthcare stocks (which are benefiting from strong cash flow) and technology (which should benefit from increased capital expenditures). We maintain a negative view toward the financials sector.
- **Rotate toward growth:** Although positive, economic growth remains relatively weak. At the same time, corporate earnings growth should continue, but at a slower pace. In this sort of environment, growth styles are likely to outperform.
- **Stay selective:** We have said this before, but it bears repeating. The environment should continue to be marked by relatively high volatility and increased dispersion among winning and losing investments. Given this backdrop, selectivity among sectors and individual stocks will be critical, implying that actively managed portfolios capable of capturing diverse opportunities could be an attractive strategy.

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