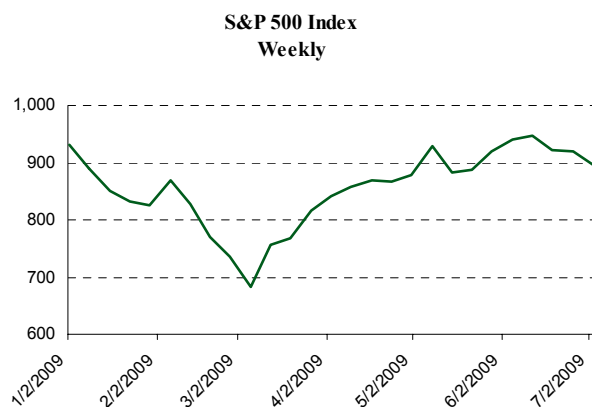




## Financial Review

Equity markets rallied sharply in the second quarter, with most benchmark indices showing modest positive results for the first half of 2009. The S&P 500 Index advanced 15.9% for the quarter bringing the first half return to 3.2%. The MSCI EAFE Index, the benchmark for International (developed) markets, rallied 25.4% in the quarter and is now up 7.9% through June.



In last quarter's review, we suggested the direction for stocks would be determined by three key factors: 1) whether economic data reveals additional signs of stabilization in the broader economy; 2) the outcome of the bank "stress" tests by the Treasury; and 3) the looming deadlines for the domestic auto manufacturers to provide feasible business plans. In each instance, the market received favorable news leading many to believe a second Great Depression was not to be.

Throughout the second quarter, economic reports indicated the process of stabilization, if not improvement, in global markets. Durable Goods orders (measuring manufacturers' shipments) as well as Retail Sales figures for

May and June were just two sets of data demonstrating improvement over the depressed levels in the first quarter. More recently, data on home construction and sales suggested a firming market. Of course, not all reports were positive - the most notable exception being the continued rise in unemployment (long considered a lagging indicator). Although it is of concern that the stated rate is approaching 10%, the latest readings suggest the rate is nearing a plateau.

Results of the Treasury's testing of bank capital adequacy - also known as the "stress tests" - indicated banks in aggregate were better positioned than many feared. Although many cast doubt over the validity of the tests, the favorable results successfully raised confidence in the stability of the overall financial system. Several banks were able to use the stress tests to justify repaying the original TARP loans leading many to believe the total taxpayer cost of all the government programs may end up far less than feared.

The third key concern last quarter pertained to the future of the domestic auto industry as years of losses weakened auto manufacturers and suppliers past the breaking point. Both Chrysler and General Motors entered bankruptcy reorganization in the second quarter, as neither company was capable of developing business plans that could support their existing capital structure. Although these potential bankruptcies were viewed as cataclysmic events just 6 months ago, it appears that the delay in the inevitable actually proved important in the firms' ability to emerge from bankruptcy quickly - and with

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a more manageable level of job losses - than earlier presumed.

The market was able to rally sharply through much of the quarter, largely because of these outcomes. In the upcoming quarters, however, we believe corporate and economic data must begin to show legitimate improvement – not just beat very low expectations – in order to justify another advance from current levels.

## Core Equity Portfolio

During the quarter, we initiated positions in Baxter, Nestle and Utility Sector SPDR, while eliminating our position in the Financial Sector SPDR.

Baxter International is a developer of medical products for hemophilia, immune disorders, infectious diseases, and other chronic and acute medical conditions. Baxter's stock has declined 30% in the last year, primarily the result of broader weakness in health care stocks due to the Obama administration's proposals for changing the domestic health care system. These concerns - at least as it relates to Baxter - may be overblown as 60% of corporate sales are outside the U.S. Although Baxter's earnings growth rate is expected to slow to around 10% (from over 20%), the recent stock decline has more than discounted this outlook.

Nestle is a global packaged food company that manufactures and markets milk, chocolate, bottled water, coffee, creamers, food seasonings and pet foods. Nestle is divesting non-core businesses, including an eye-care company (Alcon), in order to reduce debt and add to its food and beverage operations. Nestle has the leading market share in most categories in which it participates, providing

leverage both in purchasing and setting product pricing. Slowing organic sales growth has been the chief worry for investors over the past year, but this is already reflected in the stock price. From a valuation standpoint, Nestle is near 20-year lows, trading for less than 13x earnings.

The Utility Select SPDR is an exchange-traded fund (ETF) that owns all utilities in the S&P 500 Index. Valuations for utilities are attractive on an absolute and relative basis, with many trading for less than 10x earnings. With the economic slowdown moderating, fears of a continued decline in commercial usage should abate soon - stock prices for utilities, however, have not yet reflected this. Coupled with a generous yield exceeding 4%, this investment represents an attractive total return opportunity.

As long-term clients are likely aware, Core portfolios have maintained an underweight position in financial stocks for the last five years. Our underweight position was initially based on overly rich valuations in the sector and, for the past two years, concerns over potential impairments due to lax lending standards. We originally purchased the Financial Sector ETF (although still maintaining an overall underweight position on the sector) after the demise of Bear Stearns, Fannie Mae and Freddie Mac, believing that bank valuations had declined to attractive levels based on their long-term earnings capacity. We were a month too soon, however, as we underestimated the near-term economic destruction due to the dismantling of the housing/financial bubble. With the government constantly changing the rules for entities receiving financial support, and with shares nearly doubling off their March lows, we elected to sell the security and look for better risk/reward opportunities.

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Core Equity portfolios enjoyed strong gains in the second quarter with nearly all holdings participated in the broad market rally. The broader market benefited from a decided change in investor psychology from despair to cautious optimism. With considerable support from the Federal Reserve and Treasury Department, as well as the belief that the stimulus efforts enacted earlier in the year would eventually yield results, participants became more confident that the financial system was in repair and that corporate profits were at or near a trough.

Now the question is where do we go from here, and how are clients' portfolios positioned considering this outlook?

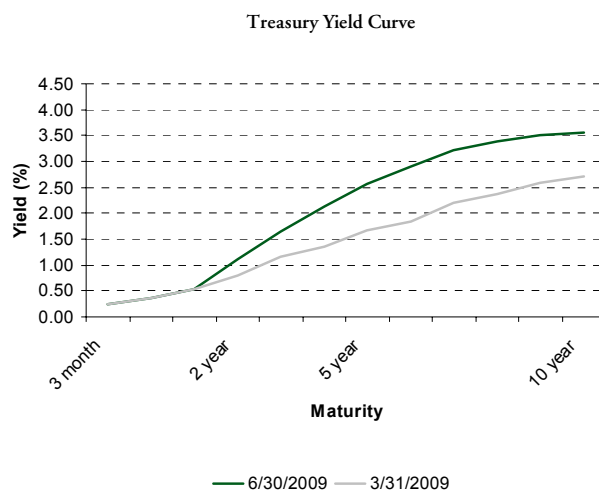
The most likely scenario for the stock market is to remain range bound for the next few months, as the markets contend with both positive and negative economic and corporate data. Recent economic figures suggest the rate of decline in the economy has diminished to the point that most observers are now calling for growth in GDP in the third quarter. We believe, however, that it is premature to expect a bull market just yet, as there are numerous factors hindering the economy from achieving a "normal" level of growth. In addition to the continued retrenchment of the consumer, corporations are signaling a lack of willingness to increase capital investment until clearer signs of revenue growth occur.

Since we expect economic growth will be anemic for some time, we currently have stock portfolios positioned defensively with overweight positions in less cyclical sectors (Consumer Staples, Health Care, and Utilities). We do believe, however, that commodity prices will eventually move higher as the effects of global stimulus programs move to reflate commodity demand. As a

result, we maintained overweight positions in Energy and Basic Material stocks. The combined benefits of these strategies should serve portfolios well under the most likely economic scenarios.

## Fixed Income Markets

The yield curve steepened in the second quarter, as rates on intermediate and long-term bonds rose sharply – in part reflecting optimism that the stimulus and monetary easing programs in place are showing signs of stabilizing the financial system and economy. Interest rates on 10-year United States treasury securities ended the quarter at 3.56%, an increase of almost 90 basis points for the quarter.



Spreads on corporate bonds (as compared to treasuries) narrowed considerably in the quarter, as fixed income investors became more comfortable with accepting incremental credit risk. At current levels, short and intermediate term corporate bonds in the 3-6 year range are most attractive on a risk/reward

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basis. Municipal bonds also rallied in the quarter despite well-documented state and local budget problems in California, New York, and elsewhere. On a tax-equivalent basis, Municipals remain at very attractive rates for new purchases.

## Alternative Investments

Credit spreads tightened sharply during the quarter assisting the performance of **Distressed** corporate securities and **Long Credit** strategies. Lower rated credits performed better than less speculative positions as increasing optimism surrounding economic stabilization and potential recovery drove investors in search of green shoots. Notwithstanding the present optimism, default rates are on pace to hit 10% for non-investment grade loans and bonds.

Arbitrage strategies, including **Merger Arbitrage**, **Fixed Income** and **Convertible Arbitrage**, all posted positive quarterly performance. Though the “easy money” has been made as arbitrage spreads contracted significantly during the quarter, opportunities remain attractive as competition to profit from the record dislocation is a fraction of its former self.

**Equity Long/Short** strategies benefited from the market rebound and strong stock selection. With domestic equity indices slightly positive YTD, managers have been able to make money both on their long and short books for the first time in many years. As a result, Equity Long/Short outperformed most long-only indices.

**Real Estate** continues to struggle. Whether it is traditional home loans or construction loans

for new commercial development, banks have severely cut back on all types of real estate lending, choosing instead to focus on working out existing non-performing loans. Until banks loosen up their purse strings, we do not foresee a bounce in real estate prices.

## One Year Economic Overview

		Jun 2009	Jun 2008
<b>Stock Market</b>			
S&P 500 Index	▼	919.32	1,280.00
Russell 2000 Index	▼	508.28	689.66
<b>Fixed Income Yields</b>			
3-Month Treasuries	▼	0.23%	1.77%
5-Year Treasuries	▼	2.57	3.32
10-Year Treasuries	▼	3.56	4.02
30-Year Treasuries	▼	4.35	4.52
<b>Inflation Monitor</b>			
CPI-Trailing 12-Month Growth	▼	-1.4%	5.0%
CPI-(Excluding Food/Energy)	▼	1.7	2.4
Market Expectations*	▼	1.8	3.1
Gold (per ounce)	▲	\$926.60	\$925.40
Crude Oil (per barrel)	▼	69.89	140.00

\*Comparison of yields for 10-Year Treasury and 10-Year TIPS