



Special Income Strategy – Joe Tatusko

The S&P 500 ended the second quarter with little change from March 31, rebounding the last week of June to overcome a slide that started late May. It was a difficult quarter from a news standpoint with clearly weaker macro indicators of the economy alongside the Greek debt situation, the federal debt ceiling impasse, and lingering effects of the Japan earthquake that continued to cause disruptions in the global supply chain. Treasury yields fell during the Second Quarter, as fixed income investors sought safety in the face of these events.

It was a mixed bag in performance across U.S. industry sectors. Health care, utilities, and the consumer sectors did well during the Second Quarter; however, this was offset by continued weakness in the financial sector and a pullback in energy as the price of oil fell below \$100/barrel. Other industry sectors were mostly flat. Looking outside the U.S., it might surprise some that the best performing equity markets this year have been from Europe. France, Spain, Germany, Ireland, and Italy have posted positive returns in the teens year-to-date, seeming to reflect expectations that impending debt restructurings will be resolved over time. The emerging markets faced significant headwind and most EM countries were in the red for the Second Quarter.

Changes to portfolios during the Quarter generally centered on continued focus on dividend paying stocks diversified across sectors. The fundamentals remain attractive for this group from the standpoint of still quite reasonable valuations, and the best balance sheet strength seen in years among the dividend payers. This affords many companies the opportunity to return excess cash to shareholders in the form of dividend increases and share buybacks. Master limited partnerships were up or down slightly during the Quarter, providing selective opportunities to pick up attractive distribution yields in the 7% to 9% range. It remained a difficult Quarter for bonds from a yield perspective as the 10-year Treasury continued to hover near 3%. The current interest rate environment provides few opportunities to acquire investment-grade bonds yielding more than 4%, and our approach has been to place emphasis on issues with 5 years or less remaining maturity so as to reduce interest rate risk and continue to wait for the day when interest rates revert higher and are more in line with historic norms. We have also been adding to holdings in high yield bonds where appropriate, being comfortable with markedly strong fundamentals while picking up additional yield.

The economy continues to grow albeit at a slower clip, down from 3% real GDP growth to something closer to 1.5%. We expect growth to pick up toward year-end and into 2012, which should translate to favorable results for the equity markets over the coming months. Inflation appears moderate following the recent pullback in commodity prices, and the threat of wage inflation is nonexistent given substantial excess capacity and high unemployment. The employment situation is a bit of a conundrum because the unemployment rate can't go down until we're creating 300,000+ jobs per month. This requires GDP growth closer to 4%, so we need more growth which can only come when companies are confident that sufficient demand will exist to warrant new investment in people and capital goods. The restoration of this confidence has been and will continue to be a slow process of recovery.

In spite of this, we remain comfortable with the state of the markets, and right now are biased a bit more toward the developed world rather than the emerging markets as we head into the Second Quarter earnings season.

Thank you for your continued confidence in our abilities to provide you service, and rest assured we will work hard in evaluating and executing on opportunities that best meet your investment needs.

Sincerely,

A handwritten signature in blue ink, appearing to read "Joseph Tatusko", with a long horizontal flourish extending to the right.

Joseph Tatusko, CFA