MARKET OVERVIEW: An Up and Down Quarter

United States

An April rally of nearly 4% was followed by a collapse that lasted through mid-June, taking stocks down 7%. But the market picked up steam in the last two weeks and ended up the quarter on a positive note. The Dow Jones Industrial Average finished at 12414.34, up 94.61 points—its fourth quarterly gain in a row. The broader S&P 500 Index rose to 1,320.64, leaving it down 1.8% for the month of June and off 0.4% for the just-ended quarter. The Nasdaq Composite Index climbed to 2,773.52, down 0.3% for the quarter and off 2.2% for the month of June. Before the last week in June, stocks had absorbed seven weeks of losses, yet Wall Street rarely wavered from its consensus view of this economic soft patch as a short term event. From the late-April peak, the Dow took more than six weeks to decline the 7%, but just a third of that time to bounce back almost 6%. Bond prices advanced for the past three months, with U.S. Treasuries rallying as weaker economic numbers were released. The benchmark 10 year Treasury bond yield dropped by 31 basis points, to 3.16%. At the end of March, the yield stood at 3.47%. U.S. mutual fund investors added about $24 billion in net new cash during May, though primarily to bonds. Mutual fund flows were defensive in nature and led by bond funds and international equity funds. Bond funds experienced net inflows of $20 billion, as investors continued to put money into bond funds in a search for alternatives to low-yielding cash vehicles and as low-risk ways of participating in financial markets.

Reacting to disappointing economic and employment news, investors withdrew nearly $3 billion in net new cash from domestic equity funds in May 2011. That marked the first month of net outflows from U.S. equity funds since December's net outflows of $8.5 billion. The phrase "double-dip recession" re-entered the investment lexicon in the second quarter after a string of disappointing economic data releases. New figures on employment, housing, manufacturing, consumer spending all pointed to a slowdown in growth from hearty 2009 levels. The Greek debt crisis was back in the spotlight during the quarter as well. Despite severe austerity measures and attempts to raise revenue, it became clear that Greece would not be able to service its debt and that the country would require another round of bailout funds. Major stakeholders from France to Germany to the International Monetary Fund often disagreed on the best course of action to stave off non-payment. They eventually arranged to fund another

U.S. Growth Leaders Portfolio Top-Ten Holdings

1) **Oracle**
2) **Medtronic**
3) **Novartis**
4) **Exxon Mobil**
5) **Time Warner**
6) **Mosaic**
7) **Xilinx**
8) **Starbucks**
9) **Gilead Sciences**
10) **Coca Cola**

U.S. Value Leaders Portfolio Top-Ten Holdings

1) **Chevon**
2) **GlaxoSmithKline**
3) **Verizon**
4) **Total SA**
5) **USB Bank**
6) **Occidental**
7) **Duke Energy**
8) **Amgen**
9) **Bristol Myers**
10) **Proctor & Gamble**

Asset Allocation Portfolio Top-Ten Holdings

1) **U.S. Corporates**
2) **Glaxo Smithkline**
3) **Novartis**
4) **Intel**
5) **Merck**
6) **Exxon Mobil**
7) **Abbott Labs**
8) **SAP**
9) **Chevron**
10) **Pfizer**

bailout in return for further austerity measures and other concessions. In examining which stocks did well by size, Mid-cap stocks fared the best gaining 1.6%, while small-cap stocks lost 0.5%. Growth equities (up 2.7%) did better than value stocks (down 1.2%). Returns among stock sectors were spread widely. Leading the charge was the healthcare sector (up 8%), consumer staples (up 4.7%), and consumer discretionary (up 4.3%) sectors. Energy lost ground in the quarter falling 4.8% with financial services (down 5.5%) and basic materials (down 1.43) following behind. The Morningstar Government Bond Index rose 2.70% during the last quarter with the Long-Term Bond Index gaining 4.33% as yields pushed ever lower. The Morningstar Corporate Bond Index rose 2.26% during the last 13 weeks while the Morningstar TIPS Index was up 3.79% for the quarter.

Europe

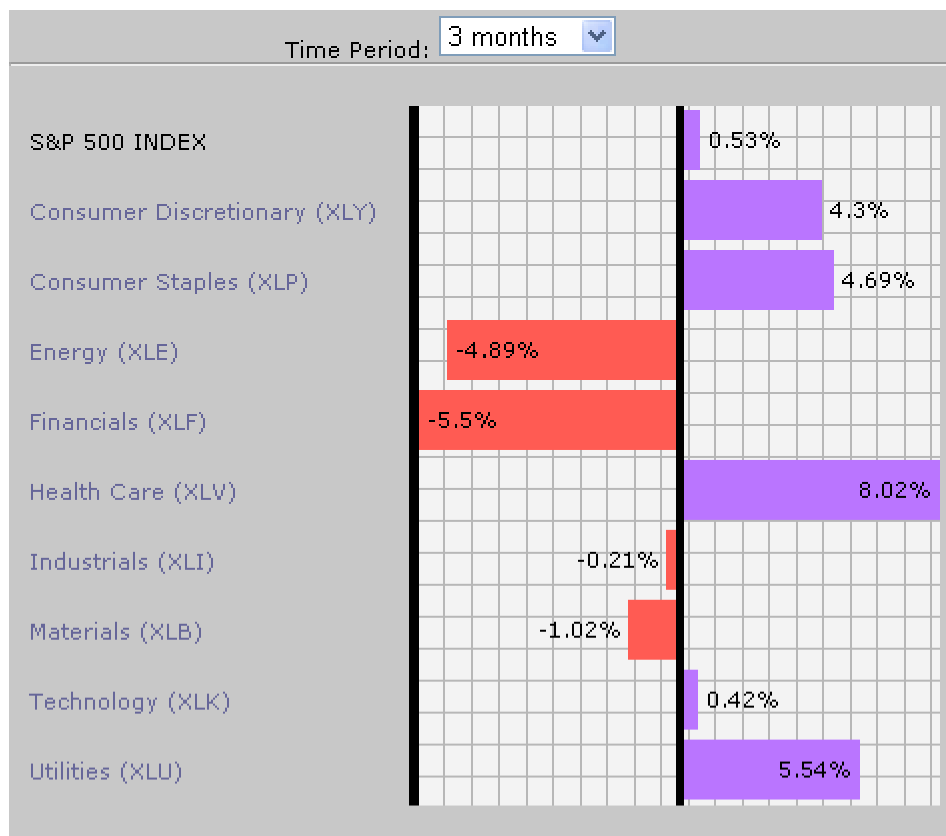
European stocks ended a lapidarian June on a strong note as investors welcomed better-than-expected U.S. economic news and a second positive vote in Greece on an austerity plan. The win for Greek Prime Minister George Papandreou cleared the way for international lenders to move forward with plans to provide the country with a new bailout package to prevent it from defaulting on its debt. The double dose of good news made investors more willing to buy riskier assets, helping the euro currency to rise above $1.45. Comments from European Central Bank President Jean-Claude Trichet added to the euro's strength, cementing the view that the European Central Bank will hold interest rates steady at July's meeting. The Stoxx Europe 600 index fell 1.1% in the quarter, snapping a string of three quarterly gains. European stocks had been rattled for much of the month by worries about Greece's finances. But investors were heartened in late June as key banks showed signs of being willing to participate in a second bailout for the country. News that German banks were willing to follow in their French counterparts' footsteps and roll over some Greek government debt helped to underpin sentiment. Among major European indexes, the U.K.'s FTSE 100 and Germany's DAX both posted gains for the quarter, although only the DAX rose in June. The DAX ended the second quarter up 4.8% while the FTSE edged up 0.6%, France's CAC-40 ended with losses for both the month and the quarter. The Paris based index fell by 1.1%. Ireland's ISEQ rose by 2.7%, making it one of Europe's best performers.

Asia

Asian stock markets closed out the second quarter in the red, as investors fretted about economic growth trends that remain unclear going into the second half of the year. The Shanghai Composite Index shed 5.7%, India's Sensex fell 3.1%, the Australian S&P/ASX 200 index lost 4.8%, and South Korea's Kospi declined 0.3%. Hong Kong companies trading with sharp losses in the quarter included apparel group Esprit Holdings Ltd., which tumbled 32% in the quarter, and consumer-products firm Li & Fung Ltd., which was down 22%. Hong Kong's Hang Seng Index dropped 4.8% overall. The Nikkei ended the April-June quarter up a tad and thus beat many of its peers, supported by signs that Japanese companies are recovering fast from damage after the devastating earthquake in March. The Japanese Nikkei Stock Average edged up 0.6% after March's earthquake rearranged prospects for the growth in the Japanese economy, with reconstruction efforts expected to provide a boost going ahead. Power companies made hefty gains, with Kyushu Electric rising 4.2 percent after the governor of Saga prefecture, home to a 36-year-old

nuclear plant operated by the utility on the southern island of Kyushu, signaled he was not opposed to restarting reactors there. Confidence was further boosted by data released in late June showing Japan's industrial output jumped 5.7 percent in May, rising at a much faster pace than in the previous month.

SURVEYING THE SECTORS



There was a wide spread in performance between the major sectors in the second quarter of 2011. Healthcare excelled, advancing by over 8%. On the opposite scale, energy and financials were both negative for the quarter. As broad economic concerns persist, investors spent the quarter increasing their exposure to those sectors that do best in a slow economic environment, including healthcare, utilities, and consumer staples.

Energy stocks declined by nearly 5% in the past three months. The past quarter saw oil prices fall from over $110 a barrel to the mid $90s. The price decline was brought about by weaker than expected U.S. economic growth. This news alongside ongoing concerns about potential European defaults, plus a slight deceleration in China's growth in recent months, cast a shadow on global growth prospects. We think the supply and demand tensions are balanced very closely, and that high oil prices are here to stay. Looking forward over the next several years, we continue to see oil demand growth outpacing new supply, and barring a collapse in demand as a result of economic weakness (potentially caused by high oil prices), marketplace fundamentals will continue to support high oil prices. In our view, the same supply constraints that support prices also support our thoughts on deepwater drilling. We own several

companies that are tied to the deepwater industry including Transocean, Diamond Offshore, and Devon. Natural gas has also suffered this year. Thanks to an influx of foreign capital and improved drilling and completion techniques, gas producers have created a glut of shale gas that has kept prices low. Although prices remain stagnant, the longer term merits of natural gas remain. We remain constructive and own several large firms that have exposure to the gas industry including Hess and EOG Resources.

The financial sector was the worst performing sector in the second quarter, falling by 5.5%. Regulation has been one of the biggest burdens on financial services stocks since the financial collapse of 2008. The important one-year anniversary of the Dodd-Frank Act will occur in July, but many of the act's most relevant provisions have been delayed as regulators struggle to implement rules on time amid galvanic debate. For example, some of the major derivatives-related provisions originally scheduled for mid-year are being pushed back to the end of 2011. Similarly, the Basel III observation and implementation process will last for years, not months. For the most part, the new costs of many regulations will be eventually passed on to consumers, but for now it has severely impacted the profitability of some lines of the banking business. The U.S. economy has not given financial stock investors much to be excited about either. Unemployment is high, housing remains in the dumps, credit growth is anemic, and the stock market is roughly flat year-to-date. Despite the headwinds, we think the sector is now very oversold. Many of the large financial firms are also now trading at trough valuations close to book value. We took advantage of the sector weakness and added some select financial names that we feel have the best balance sheets within the industry. These include Northern Trust and USB Bank.

The healthcare sector had the top return in the quarter, up over 8%. Although relatively late to the upswing in the stock market, healthcare stocks have finally caught a tailwind. With economic growth moderating along with improvement in healthcare reform-related costs, we believe the investment community has gained increased confidence in the sector. Furthermore, as uncertainty with the overall market's outlook increasing, the defensive nature of health care is also appealing to many investors. Even with the recent healthcare rally, we continue to think there are attractive investment opportunities across a number of industries within health care. Our favorite at the moment is pharmaceuticals. The valuations within the sector is still very moderate with price/earnings ratios at or below 10, versus a market price/earnings ratio average of 15. Many drug firms are now delivering excellent top line growth. One of the key elements to the success in the pharmaceutical industry is emerging markets. Historically, emerging markets have not been attractive for branded drugs. Incomes in these geographies were too low to pay for drugs, and the lack of respect for the law along with poor law enforcement of intellectual property led to rampant counterfeit drugs. However, the wealth explosion and the importance of brands signifying quality have created very important new markets for the drug industry. We hold several firms that will benefit from this trend including international firms Novartis, Roche, and GlaxoSmithKline.

SIPCO PORTFOLIO REVIEWS

U.S. GROWTH LEADERS PORTFOLIO

The SIPCO growth portfolio had a 2011 second quarter return below the major stock averages, down 1.6%. Our overweight position in the energy and financial sectors had a large impact on fund performance during the past three months. As mentioned, the energy sector dropped by 4.8% while the financial sector fell 5.5%. Within energy, all of our growth holdings faltered. Our weakest performers within the energy sector for the past three months were Transocean (down 19%), Hess (down 16%), Devon Energy (down 16%), and EOG Resources (down 12%). The energy sector was the top performing sector for early 2011, based primarily upon favorable quarterly earnings and an acceleration in the price of oil over $100 a barrel. We currently have a 19% weight in the portfolio within the energy sector. This weighting is twice of that of the S&P 500 stock index. So what was a tailwind during the first quarter of the year became a liability for us during the second quarter. However, as we strongly believe in the long term merits of the energy sector and the high probability that $100 oil is here to stay, we added to our position during the past three months. We added more funds to Transocean, increasing the weight in the portfolio from 1.5% to over 3%. We are confident that Transocean, the largest deep water drilling firm in the world, will overcome its weak earnings growth results in 2011 and post strong returns the second half of the year. The company should receive favorable news soon regarding Brazil's pending contracts for its Tupi oil fields. As the financial sector struggled mightily in the second quarter, our growth stocks also dragged down performance. Nomura, the Japanese brokerage firm, cascaded nearly 20% after the earthquake in Japan in the first quarter and an additional 6.8% in the second quarter. Goldman Sachs also maintained poor relative performance, dropping 18%. Bank of New York cascaded 17%. As with energy, we did take advantage of the marked selloff to add to the group on weakness, adding Northern Trust. Northern Trust (NTRS) is a large custodian bank, providing services to big institutional clients such as endowments and fund managers, as well as to high-net-worth individuals. The company is also a large asset manager, with around $750 billion in assets under management. Fees from custodial and management services generate nearly three fourths of revenue, with the rest provided by net interest from lending operations. We like NTRS due to its diversity away from traditional banking. The firm is focused heavily on international markets and its global custody assets are increasing at a 30% annual clip. This diversifies NTRS's revenue base and opens the firm to faster-growing international markets. The stock now trades in the mid-$40s, down substantially from the $63 price it traded for earlier this year. We feel the stock can reclaim this higher price level by the end of the year. The technology sector also maintained a losing quarter, down a more modest 2%. Our holdings in the sector were mixed. Top holding Xilinx advanced by 8% and Symantec rose 5%. However, Google, Applied Materials, and Corning all fell by double digits. Within healthcare, where we have a sizeable 27% weight, several winners emerged including Abbott Labs, Roche, and Novartis. The three pharma firms advanced by 23%, 20%, and 14% respectively. We took advantage of the price rise and sold Abbott from the portfolio. In its place, we added to the materials sector through Mosaic. Mosaic is a leading producer of the primary crop nutrients, phosphate and potash. The firm's assets include phosphate rock mines in Florida and potash mines in Saskatchewan, New Mexico and Michigan. We think Mosaic will benefit from growing global demand for agricultural

products. We are optimistic that our new portfolio additions along with a rebound in the energy sector will lead to strong relative performance in the third quarter.

U.S. VALUE LEADERS PORTFOLIO

The SIPCO value portfolio had a positive return of 1.2%. For the year, the value portfolio has advanced nearly 7%. Performance for the value portfolio was also impacted by the large weight in energy. Large energy firm holdings Chevron and ConocoPhilips each fell by 6%. French oil company Total SA was our worst performer in the sector, falling by 7.5%. We remain overweight the energy sector in the value portfolio as well, by a margin of 10% over that of the stock index. Within the healthcare sector, our HMO stocks had exceptional returns. The HMO companies continued their strong performance building off gains in the first quarter of 2011. Cigna rose by 17% during the quarter, Wellpoint rose by 15%, and UnitedHealth climbed by 14% in value. We continue to believe that much of the good news has been now priced into these stocks, and we will look to rebalance money out of this industry into more undervalued candidates. GlaxoSmithKline was our other healthcare standout, advancing by 11% in value. We had added to our position in the British phama firm earlier this year, making the stock one of the top holdings in the fund. Other strong performers were Amgen and Bristol Myers, which each advanced by 9% in the quarter. Within the telecommunications sector, our large holding Sprint paid off, with the firm's stock rising by 11% in the quarter. We think the future is very bright for Sprint as it regains market share from leaders AT&T and Verizon. Our other strong performers in the fund were consumer companies Sysco Foods, up 12%, and spirits company Diageo, which rose by 8%. We had a limited exposure to the downdraft in financial companies, as our weighting was in low single digits due to a lack of strong firms and values within the sector. This has been the case in the fund for the previous eighteen months. However, in the second quarter we made our first major purchases in the sector, upping our exposure to J.P. Morgan and also adding a new addition U.S. Bancorp. These two banks have reinstated dividends this year, which is part of our criteria in the value fund. Although there are tremendous headwinds within the sector, we feel that these two firms are 'best of breed' and the stocks will slowly work their way higher over the next twelve months. We especially like U.S. Bancorp (USB), enough to make the financial firm a top holding in the portfolio. What is unique about USB is it maintains two large fee-based businesses. The larger of these two, payment processing, is a highly scalable business that includes debit and credit cards as well as merchant processing. This unit made up 28% of revenue in 2010 and has growth and profitability characteristics distinct from a typical banking business. U.S. Bancorp also has a large wealth-management business, accounting for 8% of 2010 revenue. USB is thus further insulated from other banks in regard to dependence on traditional loan growth. We think USB can rise in price 15% over the next twelve months. Our largest detractors from quarterly performance were The Gap and Ford Motors. Both suffered from poor quarterly earnings which were released in April. Ford Motors continues to suffer from a buildup in inventory and lackluster sales. We continue to like both firms. Other poor performers included New York Times (down 12%), Texas Instruments (down 7%), and Dow Chemical (down 5%).

ECONOMIC REVIEW: A Second Half Spurt?

Globally, growth is at its weakest since the recovery began almost two years ago. Since the Great Recession ended in June 2009, gross domestic product (GDP) growth has averaged 2.8%, roughly its long-term trend. However, after so deep a slump, the pace is usually much faster. Normally growth will approach 5% during the first few years of an economic recovery. Two previous serious recessions in the post-WWII era (1974-75 and 1980-82) saw the economy roaring back with GDP growth of 5-6% or more within two years after the worst of the slowdowns. Economists and investors alike are trying to understand why the current recovery is so tepid and unemployment remains above 9%. Why is this recovery so weak? Here are some reasons. First off, residential construction and rising home prices have played a major role in every post-WWII economic recovery up until the current one. So the burst of the housing and credit market bubble serves as the primary straphanger for limp economic growth. A secondary driver for weak economic growth is unemployment, especially those workers that have not worked in years. The May unemployment report noted that the number of "long-term unemployed" (those jobless for 27 weeks and over) increased by 361,000 to 6.2 million. The long-term unemployed now make up 45.1% of all unemployed Americans, and this percentage is growing. The long-term unemployed are increasingly finding that they cannot get jobs doing what they did before the recession, as their skills have grown stale in many cases. The combination of private sector and Government training is required to alleviate the problems of the long-term unemployed workers.

Weak economic growth in the first half has also been impacted by the rising price of oil. Costlier fuel has knocked consumer confidence, particularly in gas-guzzling America. And there is still an uncomfortable possibility that further instability in the Arab world will send prices soaring again. However, at least for now, the pricing pressure is waning. America's average petrol price, though still 21% higher than at the beginning of the year, has started to fall. That should boost shoppers' morale (and their spending). The shift from stimulus is well under way. Faced with a similar sluggishness last year, America's Federal Reserve promised to jolt the economy with a second round of quantitative easing: printing money to buy government bonds. But the latest spell of quantitative easing comes to an end this month and the Fed has made clear it has no desire to add to it. Some of these policy decisions are right. With America's underlying inflation rate no longer uncomfortably low and declining, it makes sense for our Federal Reserve Bank to refrain, for now, from another round of loosening; and, on the fiscal side, the country can probably get by without further stimulus.

One bright spot recently has been the condition of the nation's manufactures. U.S. large manufacturing picked up unexpectedly in June, easing fears of a double-dip. The Institute for Supply Management's factory index rose to 55.3% in June from 53.5% in May, the ISM reported. The increase was a surprise. The consensus forecast of estimates was for the index to fall to 52.3%. The ISM index had plunged to 53.5% in May from 60.4% in April. Below the headline, the report was also firm. The key employment index improved to 59.9% in June from 58.2% in May. New orders jumped to 51.6% in June from 51.0% in the prior month. The price index fell to 68.0 from 76.5 in the prior month. Given the bright outlook from the ISM, there is hope that GDP growth might pick up in the second half. We agree and think that this slowdown in the economy during the second quarter is only a pause.

MARKET OUTLOOK

We believe stock market performance over the rest of the summer and into year-end is likely to be determined by three key tactical issues – 1) Greece passing new reforms and getting additional EU/IMF funding; 2) the US debt ceiling deal; and 3) second quarter earnings reports and guidance. On the first matter, on June 30th, the Greek parliament passed another round of budget cuts aimed at cutting the country's high deficit by boosting taxes and slashing spending. The bill restricted salaries and new appointments in the public sector and included a freeze in public sector hiring and 10 per cent cuts in social security and government operating expenditures. Although we still feel this is a short term measure with an ultimate default forthcoming, it buys the Greek government a significant period of time to delay Armageddon. Default in our view is now a 2012 event. With budget talks led by Vice President Biden slowing moving forward, we think it is only a matter of time before President Obama and the Republicans cut a deal. House Speaker Boehner would be perspicacious to start pulling together an agreement before the August deadline. Given that he has historically been a deal cutter, we think the outcome will be positive for the capital markets. The last and most important criteria for continued positive markets are second quarter earnings reports. To date, 25 S&P 500 companies with May quarter-end have reported 2Q 2011 results. These early reporting firms represent a diverse cross-section of the S&P 500 index, from consumer-exposed companies like Bed Bath & Beyond to Nike, to technology spending firms like Oracle and Adobe. So far, most U.S. companies have met or exceeded expectations: 15 (or 60%) beat market expectations on an earnings per share basis, 7 were in-line with company guidance, and only 3 companies missed projections. Surprisingly, 5 of the 6 consumer staples companies matched or beat expectations, this despite heavy winds of increasing commodity costs. On the revenue front, top line sales were also higher. Those firms that reported more sales than expected accounted for 60% of firms. There have also been scant warnings on preannouncements. Thus, the news on the corporate earnings front seems positive to us and we believe many firms will easily jump over earnings targets for the second quarter.

A critical element for the market in the second half of the year is the outlook from our Federal Reserve Bank. The entity held its regularly scheduled policy meeting last week and, to no one's surprise, elected to keep interest rates on hold. The accompanying statement and Federal Reserve Chairman Ben Bernanke's follow-on news conference made it clear that the central bank has downgraded its assessment of US economic growth. The Fed did, however, underscore that the factors causing the weakness were mostly transitory, in particular highlighting higher fuel and food prices and disruptions from the natural disasters in Japan earlier this year. Looking ahead, we are not expecting to see any near-term changes to Mr. Bernanke's position. We think there is virtually no chance of additional quantitative easing measures (i.e., we will not see a QE3). Conversely, given a slow recovery, we do not expect any inflation problems to become evident in the third quarter. We expect that inflation will not become an issue until at least mid-2012.

In regard to our outlook on bonds, we are more pessimistic. Due to investor "risk aversion", 10-year Treasury Bonds have continued to rally with yields breaking below 3.0% in late June — a stunning 0.75 percentage point drop since mid-February highs. We had anticipated this decline as the bond bears had jumped all on one side of the trading ledger earlier this year. Even noted bond trader Bill Gross from PIMCO told everyone to sell Treasury bonds in

February. But with the soft patch in the economy alongside a steady demand for yield by individual and institutional investors, yields were bound to decline. Our concern now is a "Reaching for Yield" effect should evoke caution for any bond investor. The last time investors reached for yield during a plummeting rate environment in 2002, the result was an explosion in issuance for subprime mortgages. While corporate financials and fundamentals do appear healthy, and we are not equating today's new debt issuance with that of 2003-2007, we believe that investors in these bond asset classes may see diminishing potential for returns, like entering the eighth inning of a nine-inning game. We think yields have bottomed here at just below 3% and will head higher for the balance of 2011. We have purchased rising interest rate funds in our bond portfolios to protect against capital depreciation in individual bond prices.

Technically, there is support for the market heading into the third quarter of 2011. The Dow Jones Transportation Average (DJTA) kept its market leadership and broke to a new high during the last week in June. Relative strength for the Transports bodes well for the Dow Theory, which remains on a buy signal from mid 2009. Copper, another one of our favored indicators, has also broken to the upside. This indicates to us that we will most likely see a small reacceleration in the economy during the second half of the year. We should move from the tepid 1.8% GDP growth seen in the first quarter to a more normalized 3% during the back half. Sentiment is also on the side of the bulls. The Sell Side Indicator from Merrill Lynch is one of our favored indicators. The survey is based on the average recommended equity allocation of Wall Street Strategists as of the last business day of each month. We have found that Wall Street's consensus equity allocation has historically been a reliable contrary indicator. In other words, it has historically been a bullish signal when Wall Street was extremely negative on stocks, and vice versa. The ML Sell Side Indicator recently pulled back slightly in June. At 58.2%, the indicator remains squarely in Neutral territory (above the current Buy threshold of 51.9% and below the Sell threshold of 63.4%). Given the contrarian nature of this indicator, we take some comfort in the fact that Wall Street strategists are still recommending that investors should be underweight equities when compared to a traditional long-term average benchmark weighting of 60-65%. Individual investors are also chiming in with strategists. Stock allocations by individual investors fell to a nine-month low in June, according to the most recent AAII Asset Allocation Survey. Individual investors held 59.5% of their portfolio dollars in stocks and stock funds, a 1.5 percentage point drop. This was the first time since September 2010 that equity allocations were below their historical average of 60%. Overall retail investor sentiment according to the weekly AAII did improve slightly along with the recovering stock market, to 38% bullish. But this is also still far below the 60% plus reading you would normally see during a toppy market. Overall, both company earnings results and sentiment indicators are flashing a green sign. Thus, we are optimistic for a positive third quarter.

We appreciate your continued trust and confidence. Please call with any questions regarding your portfolios.