

FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

MARKET COMMENTARY

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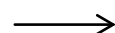
Equity markets officially entered a correction phase during the second quarter. After peaking in late April, broad market indexes fell more than 15% through June 30. The market weakness was not confined to the U.S. as markets in Europe and Asia declined as well. In fact, the pain was even more pronounced in some overseas markets; the China Shanghai index dropped about 25% the last two months of the quarter. Despite the short-term pullback, domestic equity indexes still posted above average gains for the year ending June 30 due to the fact that the markets were in the early stages of the cyclical recovery last summer when the period began. Our portfolios generally lagged the indexes for the quarter but remain well ahead of them for the last twelve months.

With wounds from the 2008 market collapse still fresh in the minds of investors, the recent market sell-off has raised new fears among many that the next bear market is just over the horizon. There are legitimate concerns for investors to consider, but we believe current market valuation levels reflect these fears. The explosion of the Deepwater Horizon oil rig in the Gulf of Mexico in April certainly impacted investor sentiment beyond the direct stock market declines of BP, Anadarko and others involved in the disaster. We expect that further government regulation will follow, which means energy exploration will likely be the next industry--after health care and finance--to be subject to "reform." While in this case we do not condone any reckless actions of these companies, reform usually results in higher taxes and fees for industry participants and lower earnings for investors. Often, some of these increased costs are passed on to consumers and have a negative impact on consumption. The fallout from this unfortunate situation is undoubtedly weighing on the stock market.

Also troubling to the market is the fact that the strength and sustainability of the economic recovery remain uncertain. First quarter GDP in the U.S. was recently revised down to 2.7%, a relatively low level considering we are still in the early stages of an economic expansion. At best, it appears that economic activity has hit a soft spot, with the momentum of growth slowing worldwide, even in emerging markets where the absolute level of growth remains high. The debt crisis in Europe brings to the forefront the challenges faced by governments as they seek to balance stimulative spending and skyrocketing budget deficits. Greece was the first to make headlines with this dilemma, but other countries, including the U.S., will deal with similar issues over the coming months and years.

On the positive side of the equation, earnings reports so far in 2010 have generally been better than expected. Most companies in the U.S. have emerged from the recession with lower cost structures, improved margins and strong cash flow-generating abilities. For the most part, corporate balance sheets are solid as well, with cash levels higher than normal. We expect that when management teams become more confident in the sustainability of the economic recovery, they will use this cash for capital spending projects or for mergers and acquisitions. Furthermore, valuation multiples appear attractive at around 12 times expected earnings for the market.

We believe that long-term investors should capitalize on fear-driven markets by increasing their exposure to stocks that become more attractively priced during the correction. There are always reasons to be cautious and it takes conviction and discipline to invest when markets are falling. Historical data suggest that times of uncertainty provide the best opportunities. We purchased three new stocks in the last four weeks, each of which possesses attractive fundamental outlooks and inexpensive valuations. Stocks were added to the Industrials and Finance sectors. Each of these stocks offers strong return



potential as they trade at significant discounts to our full-value target prices. Early during the quarter, our cash levels rose as we exited several stocks that met our target prices. We also reduced our weightings in others, which neared their target prices. The result of this trading activity is a lower price-to-value ratio, another way of saying we improved the portfolio's risk-versus-return profile.

After more than a year of relatively strong performance, our portfolios trailed the benchmarks for the second quarter. The bulk of the underperformance for the quarter was due to poor performance from a small number of stocks in the Consumer Staples and Information Technology sectors. We continue to find these stocks attractive and have used the market pullback as an opportunity to increase weightings in several of these names. Our bottom-up approach seeks to identify high quality companies with undervalued stock prices resulting from short-term business challenges. If we remain convinced that the investment case holds valid, we will use these occasions to add to our positions.

As often occurs, economic concerns led investors to seek the perceived safety of the bond market. This behavior was evident this past quarter as an influx of buyers drove bond prices up and interest rates down. Additionally, a very pronounced flight to quality occurred, leading to strong outperformance by U.S. Government bonds. Yields on government bonds fell to near 50-year low levels with the 10-year bond yield under 3%. Given these low yields, it is especially important now to maintain a short maturity structure. This would minimize the negative returns in bonds that will inevitably accompany higher interest rates once economic conditions improve.

We are optimistic about future returns from the stock market. Competing investments, such as bonds and cash, appear to offer limited return potential while stock market valuations following the recent correction are much improved. At FBP, we focus on the long-term investment case for the stocks we own. That approach allows us to take advantage of the volatility created by fear, and sets the stage for positive returns in the future.

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