

FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

MARKET COMMENTARY

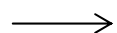
January 2010

Stock indexes advanced by approximately 5% in the fourth quarter, capping off an extremely volatile, albeit successful year in a relatively benign manner. It was the first quarter since September 2008 with single digit returns—positive or negative. Stocks rebounded sharply following the market bottom in March, with the broad market indexes returning 20% or greater for the twelve-month period despite fears that were present early in the year. With the end of a severe bear market and the beginning of a rally that has been among the strongest we have seen in 40 years, 2009 will be remembered as one of the most manic years in investment history.

2009 punctuated a decade that ranks among the worst in history for equity investors, with the S&P 500 producing negative returns over the full period. At the start of the decade the technology bubble was fully inflated and, with the S&P trading at nearly 30 times earnings, valuations were stretched. That bubble burst in 2000 and was followed a few years later by excesses in housing, commodities and most anything that could be leveraged to produce higher returns. The deflating of this most recent bubble produced the difficult bear market of 2008-2009 and contributed to the very poor results for the 10-year period. Contrasted with the beginning of the last decade, this new decade begins with valuation levels much more reasonable, at around 15 times 2010 earnings estimates, and should allow for future returns to be in line with historical averages of between 7-10%.

What lies ahead for stocks in the coming year? Will the bear rear its ugly head again or will the rally continue? Obviously, there are concerns. Unemployment remains at 25-year highs. Commercial real estate loans are beginning to show some stress. Economic growth is relatively muted given that we are emerging from a recession. A major challenge for the Fed will be the gradual removal of the economic stimulus without damaging the underlying economy. This is crucial, as low interest rates and expanding government debt loads must eventually be unwound. While we expect tax rates to move higher, we believe increased taxes alone will be insufficient to pay down government debt. GDP growth will be required over time to generate higher tax revenues capable of lowering the national debt. But back to the question of what lies ahead: virtually every leading indicator is signaling that the economic environment will continue to improve. With the Fed likely to remain accommodative for the foreseeable future, we expect GDP growth around 3.5% for this year. Corporate profits could potentially surprise on the upside in 2010 due to the significant cost cutting by corporations during the recession. And it appears that large amounts of investable assets—upwards of \$3.3 trillion—remain on the sidelines in money market funds. At some point, given the low absolute yields available in these funds, we expect many of these dollars will return to the equity markets providing fuel for further advances in stock prices. These factors, along with the reasonable valuation levels mentioned above, paint a positive picture for the equity markets for 2010.

The bond market experienced its own dislocations during the year. U.S. Treasury bonds held up better than corporate bonds during late 2008 and early 2009, and yield spreads widened



to historically high levels of more than 500 basis points for quality bonds. As it became clear that the economic situation was stabilizing in mid-2009, corporate bonds began to outperform governments and yield spreads narrowed. For the year, corporates provided positive returns while governments were negative. Thus, due to lower government bond exposure, our fixed income performance was generally above the benchmarks. With an improving economy and the need by the Fed to withdraw liquidity at some point in 2010, we expect interest rates to work higher over the course of the year. Therefore, to protect the principal value of the fixed income assets, we will continue to maintain a bias towards shorter maturities.

Our equity returns also compare favorably to the benchmarks for the year. Stock selection was especially additive to relative performance for the year, specifically in the Energy, Consumer Discretionary and Industrials sectors, and our overweighting in the Information Technology sector helped as well. Holding back returns were our overweighting in Consumer Staples and stock selection in the Materials sector. Overall, we are pleased that our investment disciplines delivered strong results during a difficult year for investors. As we have mentioned in the past, adherence to disciplines during periods of poor performance is not an easy task, but is paramount for success, and has helped us to deliver solid returns over longer market cycles.

While we expect a positive year for equities in 2010, we believe the likelihood of continued market volatility is high. Although our cash levels have risen marginally in the last few months as some stocks have moved to our full value target levels and been sold, the portfolio continues to sell at an attractive discount to our expected value. To enhance return potential, we continue our quest for attractive, large cap companies exhibiting strong cash flow, above-average dividend yields and inexpensive valuations.

For additional information, please visit our website at www.fbpinc.com. As always, we appreciate your continued interest in our firm. We hope you have a happy and prosperous 2010.

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