

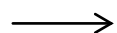
MARKET COMMENTARY

January 2011

2010 finished with a bang for equity market investors, with broad market indexes up around 10% for the quarter. Most of the calendar year return for stocks was concentrated in the latter months, which proved to be quite eventful from a political and economic perspective. The overriding theme was that fears of a double-dip economic recession evaporated so investors felt that it was safe to go back in the equity market. As would be anticipated in the face of better economic growth expectations, fixed income markets were punished as yields moved higher. After the severe bear market of 2008, stocks have now strung together two years of double-digit returns, and net money flows into equities have just begun to occur.

Following the Fed's announcement in August that it would provide additional stimulus to the economy through another round of so-called "quantitative easing," it became clear that the midyear double-dip scare was overblown. In the second half of the year, economic reports mostly confirmed that the economy was showing slow, but steady growth. Consumer confidence improved, retail sales moved higher and the Purchasing Managers Index ticked up. Unemployment remains elevated and housing market improvement has been spotty, but overall the economy appears to be on more solid footing now than it did entering 2010. The November elections signaled a shift in the political landscape as well. Sharp gains by Republicans in the House and Senate elections led to a move towards the center by the White House and Democratic Congressional leaders, and a major compromise on extending the Bush-era tax rates was approved. Removal of this tax uncertainty is positive for consumer confidence. Looking ahead, we expect more of the same from the economy—modest 2.5-3% GDP growth with pockets of weakness still lingering. At some point, the Fed will need to begin tightening by removing stimuli and raising the fed funds rate. We do not expect these actions for some time however, as we believe the Fed will wait for signs such as unemployment declines and higher inflation before it acts. Meantime, the U.S. government budget deficit will likely remain elevated. Ideally, economic growth will generate higher revenues in the coming years, but spending cuts will be needed to address the issue over the long term. This dilemma is playing out in Europe, with a series of sovereign debt crises making headlines last year. Generally tighter fiscal and monetary policies worldwide could slow global growth expectations in the coming quarters.

Commodity prices surged during the year, another indication that economic activity was improving. The Energy and Materials sectors were the best performing groups for the quarter, not surprising since crude oil, metals and even cotton showed strong upward price movement during 2010. Economically sensitive sectors such as Consumer Discretionary and Industrials also delivered very strong performance for the quarter and year. Generally speaking, smaller capitalization stocks outperformed larger cap names. Somewhat surprising to us was the fact that the Information Technology sector, which has some economically sensitive characteristics, underperformed. Our overweighting to this group, which is dominated by large-cap, high-quality stocks, held back our relative returns for the quarter and year, as did selected stocks in the



Consumer Staples sector. Strong performance from our portfolio of financials and energy stocks helped offset some of this underperformance, but we still modestly lagged the benchmarks for the year. However, our portfolio has significantly outperformed the Russell 1000 Value and S&P 500 indexes, since the market bottom of early 2009.

Increasing evidence of economic improvement lifted investors' appetites for stocks and has brought about poor performance from fixed income assets. Yields moved sharply higher as investors began to expect a stronger economy going forward. In fact, yields for the 10-year Treasury bond spiked up almost 1% during the quarter. With bond prices moving inversely to yields, negative returns were generated by broad bond market indexes. With the absolute level of yields at very low levels compared to history, we had been anticipating an increase in yields for some time. Our relative performance was very strong for the quarter, but it was not enough to catch up to the indexes for the year. Yields are still low by historical standards and we expect additional increases in interest rates in 2011; therefore, we believe maintaining a short duration, defensive portfolio of investment grade corporate bonds is appropriate for that environment.

The consensus outlook from Wall Street analysts is that stocks will generate double-digit returns this year, while bonds will produce negative returns. Given our constructive view of the economic environment, it is hard for us to argue against the consensus view. Therefore, we remain generally optimistic about the potential returns from stocks. At just over 13 times 2011 earnings estimates, which are generally moving higher, valuation levels for the S&P 500 appear reasonable. It is likely, however, that the market rally near year end "pulled forward" into last year some of the return potential for 2011. We are also optimistic about the potential for large cap stocks to outperform mid and small caps this year. We believe their underperformance recently has given them a valuation advantage over small stocks, and their more predictable earnings streams should prove to be relatively attractive to investors.

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