



July 27, 2010

Dear Client,

Positive economic growth continued worldwide during the second quarter of 2010 and is highly likely to continue climbing through 2011. Cyclical economic indicators showed sustained recovery or stabilization. Global corporate profitability, especially in the US, extended its steep rebound producing solid cash flow generation, high cash reserves and strong balance sheets. Global stock valuations generally are undervalued and show fairly positive prospects.

Nonetheless, the second quarter was unsettling for investors as the global financial equity markets experienced a correction, witnessing declines across the board (see Exhibit 1, p.3). The relative performance of diversified portfolios fared much better as most fixed income securities enjoyed strong positive returns. In US equities, mid and small cap companies were able to cushion the market's negative impact, experiencing smaller declines compared to returns of their larger cap counterparts. Internationally, diversification into emerging markets mitigated the impact of large overall declines in international equities, especially those of European companies. On average, alternative investments (hedge funds) also protected portfolios during this period.

The Greek economic crisis – and its possible extension into other European and global economies – dominated investors' concerns worldwide and more than overshadowed both positive global economic developments and strong corporate returns. The US equity market's 'flash crash' of May 6th raised further concerns as to the stability of financial markets (a reminder of 2008), thereby adding another layer of investor apprehension. Lackluster US job growth weighed on US consumer sentiment, creating additional economic uncertainty among small and mid-sized businesses, which are relatively more consumer dependent. In addition, investors became concerned that the Chinese economy – a key element in global economic recovery – might be stunted by a tightening of fiscal and monetary stimulus policies. These events were among the most substantial drivers of the market correction.

Recent surveys of business outlook and sentiment offer a noteworthy dichotomy of views between CEOs of large versus small/mid-sized companies. A preponderance of large-company CEOs are optimistic and foresee stronger business conditions and company growth. In general, they plan to increase investments in plant and equipment and boost employment. Since many of these companies are generating large cash flows, they can finance these planned expenditures without obtaining any outside financing.

On the other hand, owners and executives of mid-sized businesses feel more uncertain, are more pessimistic and plan on exercising caution regarding future capital expenditures and hiring. Additionally, these smaller businesses rely on outside credit to

finance their expenditures, which currently is not readily available on reasonable conditions.

This dichotomy in outlook is typical of an economic recovery led by business investment and exports rather than by consumer spending, which was the case in many of the recent recoveries. While business investment and exports by large corporations drive strong GDP growth, gains in employment remain relatively modest since most large corporations are highly capital intensive. Conversely, small and mid-sized companies are the main generators of employment, but are more dependent on the consumer for growth.

It should be noted that uncertainty as to the interpretations and implications of the recently approved legislation on Health Care and Financial Reform, as well as the impending tax increases, have dampened business sentiment (especially for small and mid-sized business). This should negatively affect the pace of investment and hiring and slow the recovery. Thus, although consumers are now spending more, albeit at a subdued pace, employment gains will occur more slowly if current conditions exist.

Although the economy is growing and most likely will continue expanding into 2011, issues still exist and some sectors (such as housing) remain fragile. Therefore, our expectations need to be adjusted for somewhat slower, yet reasonable growth. Given the depth of the 2008 economic and financial crisis and our current political climate, recovery in employment and consumer spending will be more gradual than witnessed in the past.

While we recognize the possibility that a double-dip recession will occur, we believe this is not a probable outcome. The continuing increase in economic activity across broad segments of the private sector, supported by a sustained accommodative monetary policy and the ongoing fiscal stimulus from previous programs (which should continue for at least another year), should minimize the likelihood of such an occurrence.

Financial Markets' Performance

Uncertainty in Europe and slower global economic growth expectations worldwide fueled a second quarter decline in equity markets. Within the S&P 500 Index, defensive sector stocks outperformed cyclical stocks while the financial and material sectors declined the most. US large cap stocks were hurt the deepest during the quarter since, in many instances, their large multinational operations were perceived to be riskier as the dollar strengthened versus a variety of foreign currencies.

Exhibit 1		
Total Return* for Selected Equity, Fixed Income, and Hedge Fund Indices		
	2Q 2010	Year to Date
	(3/31/10 to 6/30/10)	(12/31/09 to 6/30/10)
Major Equity Indices		
	%	%
S&P 500 Index	-11.4	-6.7
Russell 3000 Index (Total US market)	-11.3	-6.1
Russell 2000 Index	-9.9	-1.9
MSCI All Country Ex-US Index (Net)	-12.5	-11.1
MSCI EAFE International Index (Net)	-14.0	-13.2
MSCI Emerging Markets (Net)	-8.4	-6.2
<i>Source: Bloomberg, MSCI</i>		
Major Fixed Income and Hedge Fund Indices		
	%	%
Barclays Capital US Aggregate Bond Index	3.5	5.3
Barclays Capital Credit Investment Grade	3.3	5.6
Merrill Lynch US High Yield BB-B Bond Index	0.2	4.6
JP Morgan GBI Global ex-US Index Hedged in USD	1.5	0.4
JP Morgan EMBI Global Index (Emerging markets)	1.2	5.4
HFRX Equal Weighted Strategies Index (Hedge Funds)	-2.1	-0.1
<i>Source: Bloomberg, PIMCO, HFRI</i>		

* Includes price appreciation plus dividends and/or interest.

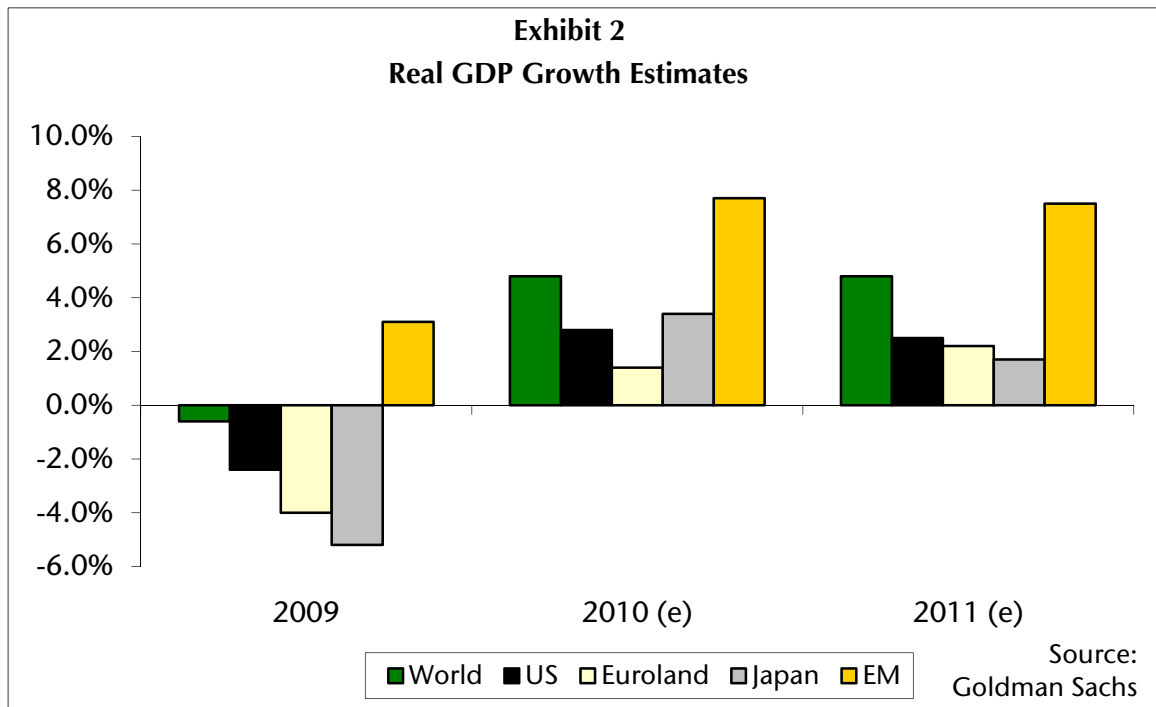
As mentioned, while deeper economic worries in the US overshadowed positive earnings reports, stocks in the S&P 500 Index were trading at a price-to-earnings ratio of between 11.5 and 13.5 (forward earnings) compared to an average historic P/E ratio of about 16, at the end of the second quarter. This translates to a current earnings yield (the inverse of the P/E ratio) of approximately 8%, as compared to a yield of less than 3% on 10-year Treasuries.

Internationally, worries over the handling of the Greek situation affected developed European stock markets and concerns over a potential slowing in Chinese growth affected emerging market stocks. Moreover, the decline in the Euro against the US dollar exaggerated the negative performance of European markets for US dollar-based investors. For example, the German stock market (as measured by the MSCI Index) fell 3% in local currency, but 12% in US dollars. However, the Yen appreciated against the dollar to near historic levels, softening the decline (in dollars) of the overall MSCI EAFE Index.

Fixed income rallied during the second quarter with domestic higher quality bonds leading the upturn. Credit spreads widened somewhat, although still are low compared to recent historic spreads. Although most investors do not see interest rates increasing in the near-term, some investors are moving towards shorter durations to hedge the impact of likely higher future interest rates. In general, commodities fell this quarter (although gold prices gained), as concerns about the global recovery surfaced and the dollar strengthened.

Economic Highlights
Credit Turmoil in Europe

As discussed above, credit turmoil in Europe continued to dominate market sentiment during the second quarter. A €750 billion financial package aimed at backstopping Greek and other Euro-zone debt obligations provided some comfort to investors and signaled that the European Monetary Union is not about to crumble. The continent’s financial interdependence lies at the heart of this credit turbulence. Large financial institutions in Germany, France and other European countries hold massive amounts of debt issued by a handful of highly indebted peripheral Euro-zone countries, including Greece, Portugal and Spain. The possible slowdown in European economic growth, resulting from austerity measures that will likely be implemented, is seen by many investors as potentially damaging to the slower than hoped for global economic and credit market recoveries, especially given Europe’s dominant share (over 25%) of world GDP.¹



While European growth rates likely will remain below historic averages for some time, we believe the potential damage to global growth rates will be small. For example, the Euro-zone countries with the most serious economic problems, such as Greece and Portugal, account for a small fraction of Europe’s economic output. Further, a weaker Euro is already boosting European exports and the prospects of slower growth have reduced the risks of near-term inflation and monetary tightening. Recent private sector surveys are more positive and the easing of credit conditions is helping the economic expansion. Additionally, fast-growing and less trade-dependent

¹ IMF report International Monetary Fund World Economic Outlook.

countries, such as Brazil and India, are unlikely to suffer significantly as European growth slows. Japan has also experienced a stronger cyclical recovery than expected. Importantly, US trade with Europe has a nominal effect on US GDP.

Global industrial production continued growing during the quarter, especially in emerging markets. Other leading economic indicators also experienced increases but at a declining rate, signaling potentially slower global growth in the second half of the year. In the US, GDP growth is expected to be somewhat lower during the last half of the year as the initial boost from the fiscal stimulus and the inventory cycle fades. Still, recent business surveys suggest that large US companies are still on track to expand hiring and capital spending in 2010.

Financial Reform in the US

Another major development during the quarter was the signing into law of the *Restoring American Financial Stability Act of 2010* – a sweeping legislative overhaul of the US financial industry. In an effort to avoid a repeat of the 2008 financial crisis, the law creates a more structured process for taking over and liquidating failing financial firms, provides for greater oversight of financial institutions and requires numerous Federal agencies to more intensively supervise the sector. The law empowers the Federal Reserve to: examine non-bank financial institutions (whose collapse could endanger the entire system); limit banks from making risky investments with their own capital; and provide greater transparency into transactions involving derivatives.

While the uncertainty of the law's passage and its implications has created some unease in the financial markets, this unease should subside as the numerous rules arising from the law are more clearly defined. However, the possibility exists that the implementation of this complex law could create unintended consequences and may not necessarily address future problems (the generals 'fight the last war' syndrome). Still, the massive legislation should remove some of the risk from the banking sector, even if that risk is allocated elsewhere in the economy.

Investment Strategy

The economic recovery, although now traveling on a bumpier road, proceeds on its upward climb. Corporations continue to significantly increase their profits, fortify their cash positions and strengthen their financial conditions. Global equities remain undervalued, creating attractive investment opportunities.

At the same time, investors remain fearful about both economic conditions and stock investments and still hold substantial levels of cash, which continue to earn nearly no interest. Furthermore, most outflows (for investment purposes) from cash reserves have been invested in fixed income securities. While hardly any (or negative) flows have been experienced by US equities, some capital has been directed into international equities. This flow pattern also has contributed to the attractiveness of equities and to the reduction of opportunities in the fixed income area. Lastly, a redeployment of this cash could be an additional catalyst for higher future equity returns.

Additionally, reacting to the recent European financial crisis, international investors have poured substantial resources into the US, specifically into Treasuries. This transfer of funds has lowered interest rates from an already historic very low level, thereby contributing to 'semi-bubble' conditions in the US Treasury market.

This combination of reasonable to low valuations, higher profits and stronger financial conditions in global corporations creates investment opportunities for equities on a worldwide basis and across sectors. At this time, it is our opinion that investing in equities provides a reasonable probability of good returns in the future.

Considering the relatively low levels of current interest rates (in both nominal and real terms) in the fixed income sector, as well as close to historic average spreads on corporate debt, investment opportunities in fixed income exist, but with lower potential returns and higher relative risk. We continue to lower duration and credit risk in portfolios, where appropriate. We also are searching for fund managers that can take advantage of market discrepancies and special opportunities in the different fixed income areas. Importantly, fixed income still remains an important component of asset allocation that allows for the timely funding of investors' liquidity needs and works well to diversify risk.

While we continue to rebalance portfolios, our focus – as always – remains on achieving your long-term investment objectives (given your risk profile) and funding your future liquidity needs. Again, we invite you to call us at (301) 881-3727 with any questions or concerns about your portfolio.

Sincerely,

The SOL Capital Management Team

Please note that past performance is neither an indication nor a guarantee of future returns and that diversification does not ensure profits or guarantee against a loss.