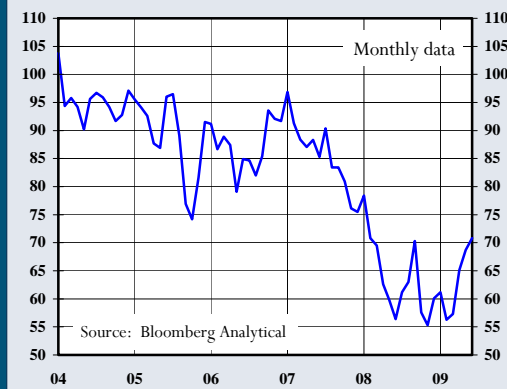


Investor sentiment shifted dramatically toward a higher appetite for riskier assets during the second quarter as the probability of systemic financial collapse faded and tentative signs of economic stabilization emerged in the U.S. After six consecutive quarterly declines, the S&P 500 Index advanced 15.9% during the second quarter. Emerging markets performed even better, with the Shanghai and Brazilian indices up 25% and 26%, respectively, and the Indian stock market up 49%. Risk averse investors with holdings in U.S. Treasuries suffered declines in value as interest rates rose during the quarter.

Perhaps the most important event which occurred over the past quarter was the disclosure of the results from the Treasury Department's "Stress Tests" of the nation's largest banks and financial institutions. The surprisingly positive results showed that most of the largest U.S. banks had sufficient capital to survive a severe economic downturn, and that the total amount of capital required by the other institutions was a relatively modest amount (\$75 billion, with \$34 billion of this amount required of Bank of America). These results helped to further propel the stock market rally which began on March 10<sup>th</sup>, and the banks took advantage of higher stock prices to achieve a significant recapitalization of the financial sector. Ten recipients of capital from the Troubled Asset Relief Program (TARP) have already repaid or will shortly repay \$68 billion in funds, thereby partially replenishing the capital base that could be available for less healthy banks if needed. All financial firms, even those unable to repay their TARP funds, are benefiting from the steep yield curve, and improved profitability levels have lessened the urgent need for the Public-Private Investment Program (P-PIP), which has been pared back significantly due to lack of participation by both potential purchasers and sellers of troubled assets.

In addition to meaningful progress made in shoring up the financial system, numerous "green shoots" in the economy helped to create positive investor sentiment. Consumer confidence has risen sharply in recent months, and consumer spending, while still weak, is showing signs of bottoming. Inventory liquidation also appears to have stabilized, and low inventory levels create the opportunity for improvement in manufacturing activity in the second half, particularly in the almost dormant automobile industry.

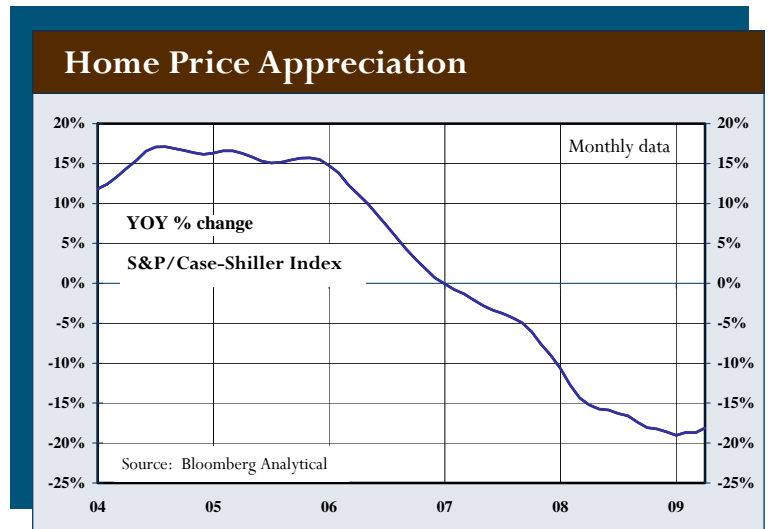
### Consumer Sentiment



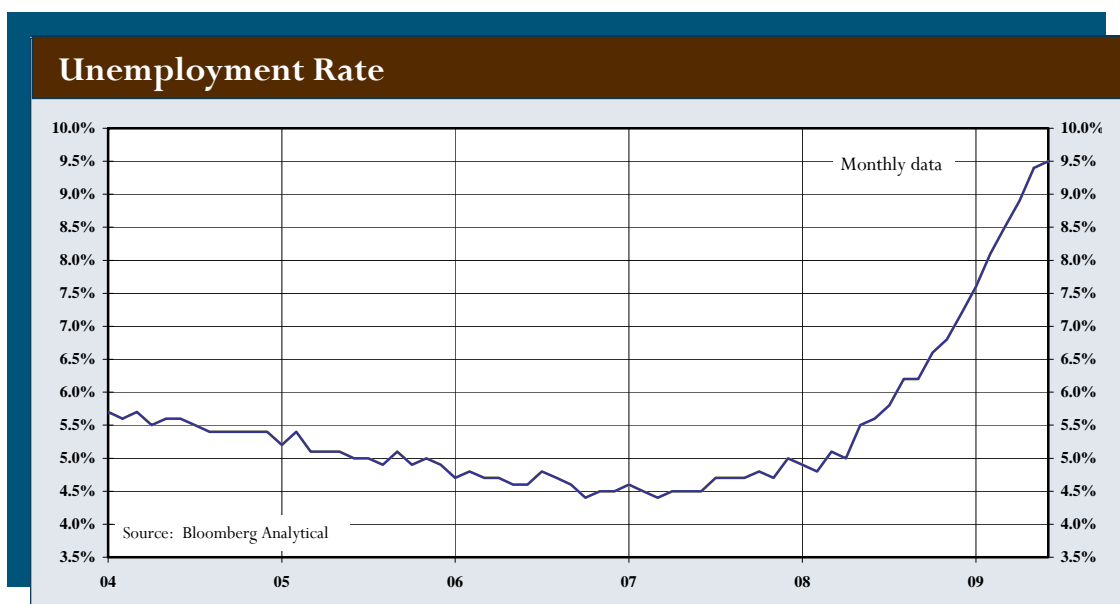
### Retail Sales



Home prices continue to decline nationwide, but the most recent S&P/Case Shiller data show that the rate of decline is slowing. In April, prices fell 0.9% as compared to the 2.1% average decline per month in the first quarter. Given the large overhang of vacant homes, it is likely that house prices will continue to decline. However, with the Federal Reserve program to purchase mortgages helping to keep mortgage rates in the 5% area, and the fact that from peak to current levels the Case/Shiller Index of home prices has declined 31%, a further decline in prices would appear to be limited to single digit percentage levels.

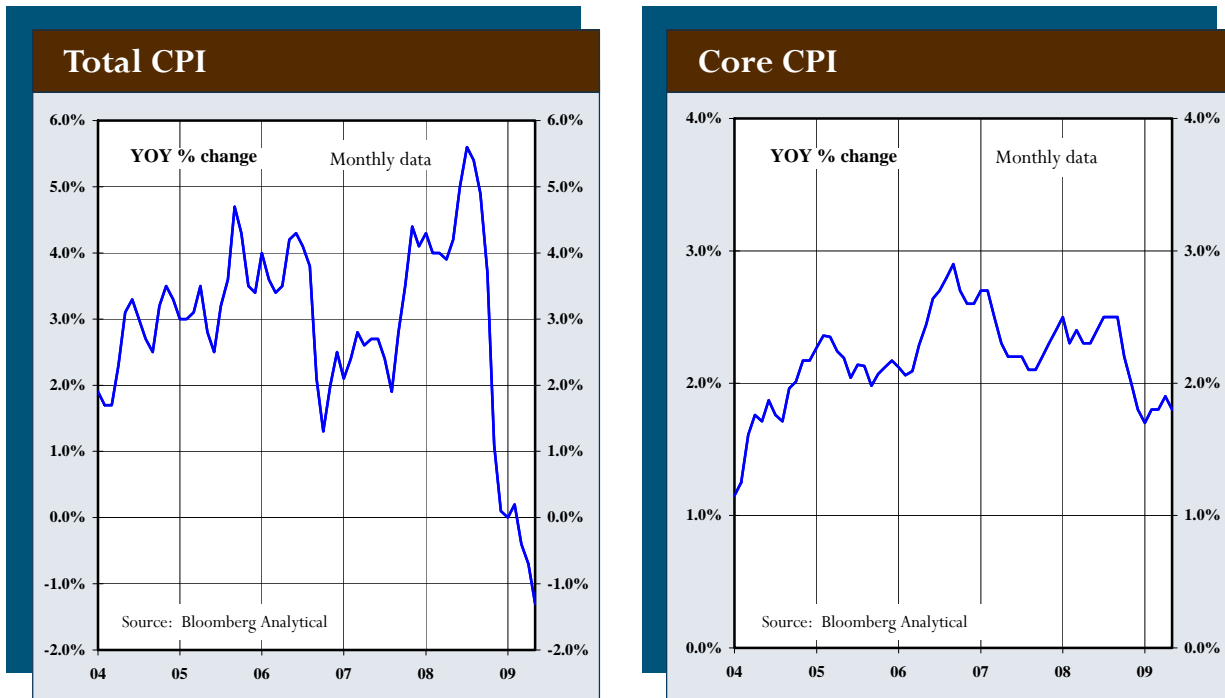


As expected, unemployment continues to rise and a disappointing June employment report recently rocked the equity markets. Unemployment both in the U.S. and Eurozone reached 9.5%, and 6.5 million jobs have been lost in the U.S. since the recession began in December 2007. In addition, the average work week fell to a record low 33 hours, and average hourly earnings rose by only \$0.03, the smallest increase since this data series began in 1964. As negative as this data is, the employment market has improved on a relative basis, with the 395,000 average monthly job losses in May and June a marked improvement from the average decline of 691,000 jobs per month in the first quarter. We continue to estimate that U.S. unemployment will reach the double digit levels, and that unemployment levels will remain elevated for a sustained period. While it is true that unemployment is usually a lagging economic indicator, the overall weak conditions in the labor market will be the primary headwind for the economy and will limit its rate of recovery.



Stubbornly high unemployment rates will inevitably result in a heightened level of calls for another fiscal stimulus, but this debate is probably a topic for 2010. Other political debates on universal healthcare, the environment (e.g. Cap and Trade legislation) and financial industry regulation all have the potential to impact specific sectors of the markets. However, the huge deficit and expanding government debt levels will limit additional material spending without commensurate expense reductions.

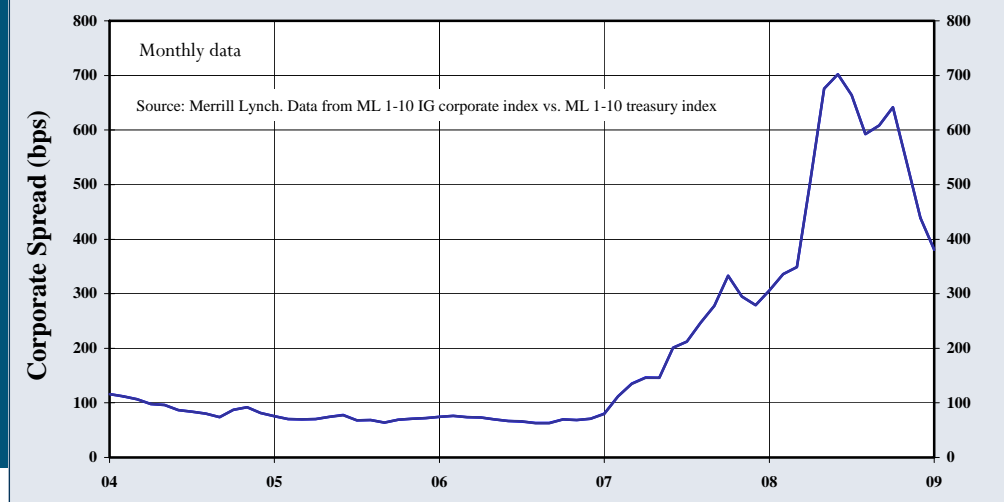
Given the unprecedented post-Great Depression level of fiscal and monetary stimulus, many investors are concerned about inflation. Our position is that deflation is the greater near term risk given the global excess capacity in labor, commodity and real estate markets, and the extremely low level of velocity of money. Additionally, the spike in the global savings rate and the decline in capital expenditures will produce additional liquidity to help meet the funding requirements of the public sector. While the Fed's balance sheet has modestly contracted over the past several months as the Fed is monitoring the effects of the stimulus and other programs already put in place, we believe Chairman Bernanke is prepared to add additional stimulus if economic conditions worsen.



In summary, we anticipate a sluggish recovery over the next several quarters, primarily fueled by public stimulus and improving economies in several emerging markets. In our equity portfolios, we have increased our exposure to cyclically sensitive stocks, and to those companies with unencumbered assets. These are companies who are not dependent on access to the capital markets to grow, whose customers do not depend on easy credit or still have access to credit, and companies which were not dependent upon the excessive consumption of the past several years. Equity markets should be beneficiaries of very high levels of cash on the sidelines and improving corporate earnings in 2010 given easy year over year comparisons.

In our taxable bond portfolios, we anticipate that Treasury yields will modestly increase given the huge issuance required and the growing desire of central banks to diversify their U.S. dollar-denominated holdings. Therefore, we will maintain durations shorter than relevant benchmarks. Corporate bond spreads have recovered to pre-financial crisis levels, but from a historical perspective they remain wide. We believe the current pricing reflects fair value given the headwinds facing the global economy. As further signs of a sustainable recovery emerge, we expect investment grade corporate bond spreads to narrow further.

### Corporate Spreads vs. Treasuries



High quality municipal bonds in the intermediate maturity range offer highly attractive tax equivalent returns as compared to Treasury yields. While it is advisable to avoid certain geographical areas, the vast majority of municipal issuers with their taxing authority powers and their need to balance budgets annually, provide solid credit worthiness and can withstand this challenging economic period.

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