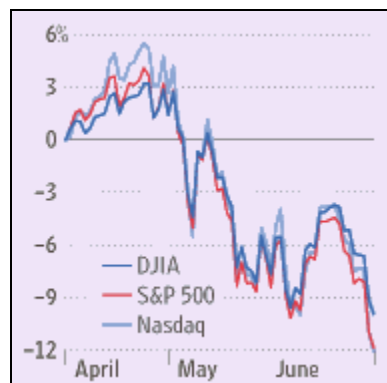


MARKET OVERVIEW: A Tough Quarter

United States

Volatility returned to global financial markets with a vengeance in the second quarter, sending investors fleeing from stocks world-wide and driving them into defensive investments, especially U.S. Treasury bonds and gold. The Dow Jones Industrial Average ended the second quarter down 1,082.61 points, or 10%, at 9774.02, its first quarterly drop since the first three months of 2009. That left it almost 13% below its 2010 high set on April 26, placing it firmly in a correction. The Dow stands 31% below its record close of 14164.53 in October 2007. However, the index is still up more than 49% from its 12-year low of 6547.05 hit on March 9, 2009. The broader Standard & Poor's 500-stock index posted its worst quarterly performance since the final three months of 2008 when the financial crisis was in full swing. With a 1% loss on the last day of the quarter, the S&P 500 fell 11.6% during the past three months to a price level of 1030.71. Meanwhile, investors flocked to investments seen as safe havens. Gold rose 12% per troy ounce to \$1,245.50, finishing the quarter just shy of its record high of \$1,257.20. U.S. Treasury bond prices also rose sharply, driving interest rates significantly lower. The interest rate yield on the U.S. Treasury 10-year note finished the quarter at 2.96%, down from 3.84% at the end of March and making Treasury bonds one of the best-performing asset classes for the quarter.

Quarterly Performance Chart



U.S. Growth Leaders Portfolio Top-Ten Holdings

- 1) Apple
- 2) Merck
- 3) Roche
- 4) Exxon Mobil
- 5) Coca Cola
- 6) Oracle
- 7) Abbott Labs
- 8) Gilead Sciences
- 9) Xilinx
- 10) Starbucks

U.S. Value Leaders Portfolio Top-Ten Holdings

- 1) Hershey
- 2) Southern Co.
- 3) Verizon
- 4) Total SA
- 5) Proctor & Gamble
- 6) Bristol Myers
- 7) Duke Energy
- 8) Ford
- 9) Chevron
- 10) Eli Lilly

International Growth Portfolio Top-Ten Holdings

- 1) Eisai
- 2) Glaxo Smithkline
- 3) Novartis
- 4) ST Micro
- 5) Delhaize
- 6) SAP
- 7) Nissan
- 8) Mizuho Financial
- 9) Teva Pharma
- 10) Barclays

Risk aversion came to the forefront during the second quarter as doubts about the sovereign debt of European countries rattled investors. The euro and non-German government bonds were hit hard by selling in May as investors sought the safest of all havens: gold, the Swiss franc, and US Treasury bonds. After reaching its highest point since the financial crisis in April, stocks collapsed in May as investors grew fearful that Greece wouldn't make good on debt payments. Its economy represents only a tiny part of the European Union but traders worried that bad debt would trip up the world's financial system the way it did after the collapse of Lehman Brothers in September 2008. Those fears morphed into concerns about how much governments around the world have been spending to invigorate growth.

The sharp turn of events marks a reversal in the "low risk" rally that began last March, and the escalation of the return of the tumult brought on by the 2008 financial crisis. Now, the question dominating financial markets as the first half closes is when will the renewed bout of investor fear will end. Unfortunately, new fears seem to keep popping up each week. In the past few weeks investors have turned their sites on China. In an effort to slow its booming economy, many fear China would end up slamming on the brakes too hard and derail a key global growth engine. As if that wasn't enough, the May 6 "flash crash," when the Dow plunged 700 points in just eight minutes, has raised fresh concerns about the soundness of the day-to-day workings of the world stock markets. Lastly, the oil crisis and the impact on the gulf coast economies and overall consumer sentiment. With investors facing this laundry list of woes, the response has been an exodus from riskier investments, especially stocks. A return of stock gains will require most if not all of these alarm bells to cease ringing.

Europe

The Stoxx Europe 600 Index fell 0.2 percent to 243.32 on the last day of the second quarter, the sixth decline in the last seven trading days. Overall, the Stoxx index fell 7.8 percent since the end of March, its first quarterly drop since the rally in global equities began in March 2009. But Europe's equity returns were not daubed evenly. The credit-market crisis spilled into the stock markets of the European countries with the most debt and weakest growth outlooks. Greece's ASE Composite Index cascaded 30.6% for the quarter, Spain's IBEX-35 dropped 14.8%, and Portugal's PSI-20 lost 12.8%. Italy's FTSE MIB Index was also hit hard, down 15.5%. France's CAC-40 fell 13.4% after rising 1% in the first period. The U.K.'s FTSE 100 lost 13.4% during the second quarter, versus a 4.9% gain during the first quarter. Germany's DAX fell 3.1%, as opposed to a 3.3% gain during the first quarter.

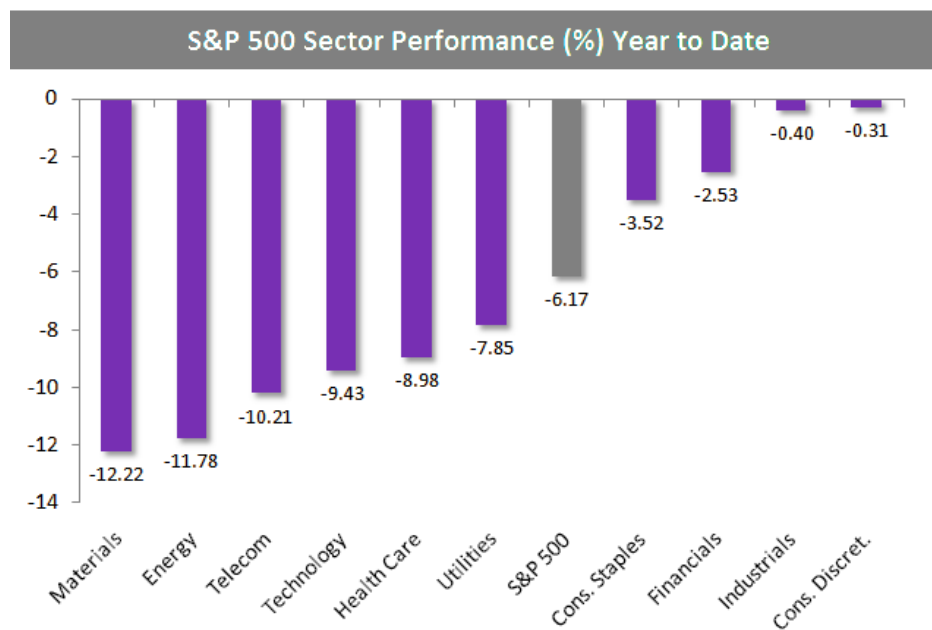
In contrast to the first quarter, when the stock indexes in larger European economies managed to stay in positive territory, major European markets suffered these dramatic declines as the economic recovery was called into doubt. Much of the blame was cast on the European Union and its currency. During the second quarter, the euro faced its biggest test in its relatively brief life as the Greek debt crisis threatened to tear apart the European Union. As investors questioned the viability of the common currency, the euro was sent into a tailspin that by early June amounted to an 11% decline against the U.S. dollar from the end of March. At one point, the euro came within shouting distance of the \$1.18 at which it exited the first day of trading when it was introduced in 1999. Investors around the world remain skeptical of European countries' abilities to solve budget-deficit woes in a slow-growth environment. In addition, the

crisis showed cracks in the basic structure of the European Union when it came to fiscal policies, solutions to which will require agreement among the bloc's fractious governments.

Asia

One look at the laggards among global stock-market performance brings a surprise: China. China, a primary engine of global growth coming out of the worldwide recession, had a difficult three months as the country tightened lending and land sales to combat a perceived property bubble and broader asset-price frothiness. Markets in China had begun to cool during the first quarter, when the Shanghai Composite Index and Hong Kong's Hang Seng Index, on which many mainland Chinese companies list, posted some of the worst performances of major global benchmarks by falling 5.1% and 2.9%, respectively. Amid the persistent concerns about reduced bank lending, property bubbles, and inflation, a tumble ensued and Chinese stocks enlarged their stock losses during the second quarter. The Shanghai Composite lost 22.9% during the three month period, leaving it in official bear-market territory for the year. The Hang Seng lost 5.2% in the quarter, and is down just shy of 8% on the year. Adding to those currencies' concerns, China's moves to also reduce its red-hot currency. In mid-June, China allowed the yuan to gradually appreciate for the first time in nearly two years, a move that investors interpreted as a sign that Chinese officials were comfortable with their economic outlook. Such a move by China had been widely anticipated, but the precise timing caught the markets off guard. Many had believed that the turmoil in Europe would keep China's hands off its currency. Instead, China has allowed the yuan to rise to 6.7909 from 6.83, where it had been pegged since the financial crisis gathered pace in July 2008.

SECTOR DATA



SIPCO PORTFOLIO REVIEWS

U.S. GROWTH LEADERS

The SIPCO growth portfolio posted a 10.7% loss in the second quarter versus an 11.7% loss for the benchmark growth index Russell 1000 Growth. Performance for the quarter was hindered by a high position in energy stocks, as the sector had poor relative performance versus the overall market. Oil drillers were the worst performers as Transocean cascaded 45% and Diamond Offshore fell 16%. Also within the oil sector, losers included Schlumberger (down 16%), Hess Oil (down 14%), and Exxon Mobil (down 12%). Despite the travails of the sector due to the Gulf oil spill, these stocks are now priced at the lowest relative level in fifteen years. We plan to hold firm on the sector, as we believe all the energy companies we own have limited exposure to the Gulf problems. Other disappointments in the quarter were our financial stock holdings. Goldman Sachs dropped 19%, Franklin Resources fell 17%, and Bank of New York declined by 15%. Within the healthcare sector, we also had several laggards including Gilead Sciences (down 18%), Medtronic (down 17%), and Carefusion (down 12%). During the past three months, we added to our position in Merck and Gilead Sciences. As we bought at the May price lows for Merck (\$33), we actually maintained a small quarterly gain in the stock for the past three months. The stock is now one of our top three holdings (alongside Apple & Exxon Mobil). Merck's new products have hit the market with fanfare, such as Januvia for diabetes and the Gardasil vaccine against hpv. Merck also purchased Schering Plough last year, and thus the firm now also has some high ranking pipeline products including Bridion, Simponi, Vorapaxar, Preladenant, and Saphris. All could be \$1 billion products within the next few years. This strong revenue picture is balanced by the ongoing cost savings generated by the Schering Plough merger. Merck's CEO indicated in its last earnings call it is still on track to achieve nearly \$4 billion in annual cost savings from the merger. The stock now trades at only 10 times earnings with a 4% dividend yield. Our team thinks Merck can climb above \$40 a share by the end of the year. As for Gilead Sciences, it has underperformed the market significantly over the past two years. The valuation is now at only 10 times expected 2011 earnings, a remarkable discount to our own fair value. We think Gilead can rise to \$50 a share by the end of next year, which would result in a 40% plus capital gain. Genzyme and Apple were our largest gainers for the second quarter. The stocks gained 4% and 14% for the past three months, respectively.

U.S. VALUE LEADERS REVIEW

The SIPCO value portfolio posted a 9.6% loss in the second quarter versus an 11.1% loss for the benchmark Russell 1000 Value index. As with the growth portfolio, the value fund had a large percentage of money devoted to energy stocks. We sold out our position in BP as we cannot determine a correct valuation for the company based upon large unknown claims. As for our other outsized energy holdings, we are staying positive on a long-term basis. We took the proceeds from BP and placed it in the French oil firm Total SA. Total SA now offers a compelling value priced at only 7 times earnings while offering a secure 6% dividend yield. Total SA also has limited exposure to the U.S. For the quarter, Total SA fell by 16%, Royal Dutch Shell dropped 7%, while Chevron was down by 3%. We still feel very positive about the energy sector, as we feel that the price of oil will continue upwards on a longer term basis. This is

especially true now that development costs will only go higher. We started the quarter with a high cash position, but utilized the proceeds and made two new purchases, Duke Electric and Marsh McLennan. Both firms have solid balance sheets and high dividend yields. We are especially keen on Duke. Duke delivers electricity and natural gas to some 4.4 million customers in the Carolinas and nearby southern states. The company also owns generation assets in Latin America. Duke is one of the fastest growing utilities in the U.S. and plans to increase electricity generation capacity by 6,000 megawatts during the next five years to meet projected demand. The firm also divested a significant portion of its merchant generation and energy trading arm, which will now limit the continual earnings drag associated with the merchant generation business. This disposition of most of its highest risk assets shifts the company's profile to more of a defensive utility. The firm has very solid financials, with an interest coverage ratio of more than 3 times and considerably less leverage than most other utilities. The firm pays a generous 6% annual dividend as well. We are of the opinion that Duke can generate double digit returns for its shareholders through a combination of mid digit earnings growth and high dividend payments. We also utilized some cash in the value portfolio to add to our position in Verizon. Verizon also has a near 6% dividend yield. We think the recent announcement that Verizon wireless will carry the Apple I phone in January of next year will boost the firm's earnings potential. In examining the other major sectors, our technology stocks also had poor relative performance. Microsoft cascaded 18%, Intel dropped 12%, and ST Microelectronics fell 9% during the past three months. We plan to liquidate our position in ST Micro and add to our healthcare position in the third quarter. We had only a scattering of stock gainers in the quarter including Hershey (up 15%), Southern Utilities (up 5%), and Sysco Foods (up 2%).

ABSOLUTE RETURN HEDGE REVIEW

The absolute return portfolio showed a gain of 11.3% in the second quarter. As always, please note that this fund looks much different from our other stock and fund portfolios as you are invested in this fund primarily to provide added diversification away from the capital markets. We had started the year believing the stock market had reached an intermediate top. We purchased the DXD and FXP funds, which advance if the stock markets in the U.S. and China fall. Although we were early in our call, the stock markets had a strong correction during the month of May. During May, this fund had a strong profit from our negative bet on the stock market, rising nearly 20% in value. We took profits from June and are now once again moderately positive on the stock markets, at least for the short term. We are utilizing several indicators, including the transport index and new lows list for confirmation of an impending market advance. However, we are still cautious on a longer-term basis, as we believe the U.S. economy will continue to struggle with high unemployment and the housing market. We are of the opinion that the stock markets will continually go through starts and stops. Our posture for the third quarter is a moderate summer rally followed by another market selloff during late September and into October. We plan to profit from these rambling price trends by buying when the markets are oversold, and selling when the markets are overbought. At present, the market is very oversold. We have continued to also hold a small position in natural gas. We have gained conviction in this asset as the gulf oil crisis continues. Natural gas development is primarily land based, and does not require the open water deep drilling that energy firms require to reach new wells.

ECONOMIC REVIEW: Deflation around the corner?

There's a new concern to add to Wall Street's growing list of uncertainties about the economic recovery: that the U.S. could slip into a scary deflationary spiral. Deflation you say, what is deflation? Deflation is officially defined as a decrease in the general price level of goods and services. Deflation occurs when the annual inflation rate falls below zero percent (*a negative inflation rate*), resulting in an increase in the real value of money – allowing one to buy more goods with the same amount of money. Deflation is regarded quite negatively, as it causes a transfer of wealth from borrowers and holders of illiquid assets, to the benefit of savers and of holders of liquid assets and hard currency. In this sense it is the opposite of inflation, which is similar to taxing currency holders and lenders and using the proceeds to subsidize borrowers. Thus while inflation can often encourage short term consumption, deflation can cause consumers to postpone consumption in the hope that prices will fall further. In modern economies, deflation is usually caused by a potent drop in aggregate demand, and is associated with a deep recession and (*rarely*) long term economic depressions. There have been three significant periods of deflation in the United States.

The first was the recession of 1836, when the currency in the United States fell in value by about 30%, a contraction which is only matched by the Great Depression. This "deflation" satisfies both definitions, that of a decrease in prices and a decrease in the available quantity of money. The second was after the Civil War, sometimes called The Great Deflation. It was possibly spurred by return to a gold standard, retiring paper money printed during the Civil War. The deflation period of 1873-96 could be near the top of the list. Its scope was global. It featured severe cost-cutting and productivity-enhancing technologies. It flummoxed the experts with its persistence, and it resisted attempts by politicians to understand it, let alone reverse it. It delivered a generation's worth of rising bond prices, as well as the usual losses to unwary creditors via defaults and early bond calls. Between 1875 and 1896, according to the famed economist Milton Friedman, prices fell in the United States by 1.7% a year, and in Britain by 0.8% a year. The third and most well known period of deflation was between 1930–1933 when the rate of deflation was approximately 10 percent per year, as part of the United States' slide into the Great Depression, where banks failed and unemployment peaked at 25%. Until the 1930s, it was commonly believed by economists that deflation would eventually cure itself. As prices decreased, demand would naturally increase and the economic system would correct itself without outside intervention. This view was challenged in the 1930s during the Great Depression. New economists led by John Keynes argued that the economic system was not immediately self-correcting with respect to deflation and that governments and central banks had to take active measures to boost demand through tax cuts or increases in government spending. They pointed out the long post Civil War period as an example of improper economic policy.

President Roosevelt took the advice of Keynes and instituted the first large government intervention program in history. Deflation finally was defeated after the onset of the Second World War. Whether or not Roosevelt's programs were responsible for the end of deflation is hotly contested. Many economists argue it was the onset of the war that ultimately reversed deflation's grip on the world economy. Today, there is prominent talk that deflation will once again rear its ugly head. And while there are a number of contrarian indicators suggesting deflation is not imminent -- such as soaring gold prices -- yields on benchmark Treasuries have once again trended below 3%. That's an indicator to many pundits that the smart money, which I consider to be the bond market money, is preparing

for the onset of deflation. Right now there is no inflation in sight and, in fact, deflation is starting to creep into the economy. The Institute for Supply Management's latest manufacturing report, unveiled in late June, offered some troubling pricing signs, with the index's prices component tumbling by 20.5 points to 57 in June from the month before. While still increasing (*above 50 indicates expansion*), the pricing index suffered the steepest drop out of all of the report's components. Among the industries reporting price declines were wood products, primary metals, machinery, and transportation equipment. It may be an overstatement to say deflation has already arrived, but the latest read on consumer prices in the U.S. does appear to set off more alarms about deflation than inflation. The consumer price index, which excludes volatile food and energy prices, was up just 0.96% in May and April combined, marking the lowest annual increases in 47 years. Inflation at the consumer level was off 0.2% in May from the previous month -- the steepest monthly decline since December 2008. Essentially, all asset classes would be worth less in a deflationary spiral, meaning the stock market would fall sharply, home prices would tumble further, and Americans' savings would depreciate. A deflationary spiral is also macabre because it really has not happened to a generation of Americans. Americans would not know how to deal with deflation, an economic term they have only read about in schoolbooks.

On the monetary side, our Federal Reserve Bank already has interest rates nearly as low as they go, leaving it without a key tool for spurring growth and demand. The real problem (with deflation), like inflation, is that it becomes self fulfilling. To be sure, most economists don't believe a deflationary spiral is a certainty. Most important, only the bond markets are beginning to price in this insidious deflation beast. Even though the Dow Jones Industrial Average suffered its worst second quarter since 2002, it still remains more than 3,000 points above the bottom, Investors apparently appear convinced that we are in for a slower recovery than a deflationary spiral. There are also a few flies in the deflation scare ointment. Gold, which is seen as a hedge against inflation, jumped to an all-time high as recently as mid-June and surged 11.9% last quarter, its biggest quarterly rise since the final period of 2007. Oil prices have remained high as well. Until the price of gold and oil start to descend, along with the capital markets, deflation will be viewed by investors as a low probability event.

MARKET OUTLOOK: Correction getting long in the tooth?

Our market direction call in January indicated 2010 would be much like the years 2004, 1994, and 1977. In each of these years, the stock markets struggled to add upon gains of the previous year's profits. For the first five months of the year, we struggled with the fact the market continued to rise without waiver. However, our patience was rewarded in May, as the Dow Jones Industrial Average's gains finally started to immergere. We had postulated that any market pullback be limited to 10-15% given the generous profit margins of U.S. firms combined with the fact that stocks are still far below their 2007 highs. After a 13% decline, we decided the market had corrected by enough to justify a reversal of opinion. We thus exited our hedge positions in early June and became more positive on the markets. We thought it judicious to reexamine the performance of the stock market in 2004 for a comparison. After a strong market rally from the tech wreck lows in March 2003 to early 2004, major world markets had six months of weakness

as momentum in global leading economic indicators peaked and China and the U.S. moved towards raising interest rates. In fact, the U.S. had an 11% correction from the spring until the latter days of summer 2004. Asian shares had a deeper 20% correction during the same period. Thus far in 2010 the financial markets seem to be tracing out something like the 2004 experience - albeit with more volatility and anxiety about deflation instead of inflation. More broadly it's often the case that the second 12 months after a bear market ends sees more constrained and irregular gains in shares.

2004 Performance Chart for S&P 500



Bear Market Table for S&P 500

US shares - bear market lows	US, % gain in first 12 mths from low	US, % gain in second 12 mths after low
Jun 49	42	4
Oct 57	31	10
Jun 62	33	-2
Oct 66	33	7
May 70	44	11
Oct 74	38	21
Aug 82	58	2
Oct 02	34	8
Average	39	8
Mar 09	69	?

As with 2004, it's often the case that the second 12 months after a recovery ends witnesses a more constrained and volatile gain in stocks. As shown in the table above, the average gain in U.S. shares in the first 12 months after a bear market is 39%, followed by an average gain of just 8% in the subsequent 12 months. This reflects a combination of factors including the market undervaluation being removed by the initial power rally in stock, and the shift in growth leading indicators from acceleration to a pause. After strong returns for the first 12 months out of last year's bear market lows it's certainly become a lot tougher to add to the gains, but provided we are correct and global economic growth doesn't lurch back into a double-dip recession, then the rising trend in shares should resume later this year. This rise should be supported by solid earnings growth, attractive market valuations, and low global interest rates. We are sanguine about the prospects for the market after a traditional pause for several reasons. First, the market is now offering investors an opportunity to buy stocks at deflated P/E multiples as the S&P 500 now trades at only 11.5x 2011 forecasts. The S&P 500 companies, on average, now yield nearly 9% if you take expected total corporate earnings over combined current prices. This is an attractive valuation not seen since the depths of November 2008. As for company executives, the Vickers Weekly Insider reports that corporate executives are more bullish today than they were at the end of the correction in February 2010. Back in mid-April insiders were selling 7.83 shares for every 1 they were buying. Last week in contrast, they were selling just 1.26 shares for every 1 they were buying. Since corporate insiders are predominantly sellers, when the ratio is close to or at par, it corresponds to attractive stock prices. Another positive is that the TRIN, or the Arms Index, developed by Richard Arms, soared to a reading over 5 in late June. These super-high TRIN days almost always lead to at least a short to medium-term market rally. Additionally, the percentage of stocks in the S&P 500 now trading above their 50-day moving averages is down to 4%. At the March 2009 lows, the reading got down to 5%, so that gives us a good idea of just how extreme this market decline has gotten. With so many of our favored indicators flashing a "buy" signal, we have turned positive and now maintain a long bias on the stock market. However, with any substantial rally, we will most likely take some profits as the iniquitous September/October period approaches.

We appreciate your continued trust and confidence. Please call with any questions regarding your portfolios.