



FAYEZ SAROFIM & CO.

Investment Counsellors

A Consistent Discipline for Fifty Years

1ST QUARTER 2010

ECONOMIC COMMENT*

Massive fiscal and monetary stimulus succeeded in reviving US GDP growth in the second half of 2009. With an assist from rapidly recovering demand abroad, US activity turned up first in the manufacturing and export sectors. Recently, there are encouraging signs that the recovery is becoming more broadly based and gaining momentum from depressed levels. For the first time since the recession began, US employers added to their payrolls in the first quarter. According to the establishment survey, payroll employment increased 162,000 in March, including some 120,000 positions in the private sector. Upward revisions to January and February data added another 62,000 jobs. Furthermore, the household survey, which captures small business activity and historically has been a more reliable indicator at inflection points, also turned up in the first quarter, registering 1.1 million new jobs. These tallies may pale next to the eight million jobs culled in the downturn and the 15 million workers still unemployed, but they are a first step in the right direction and compare favorably to the 700,000 jobs that were lost each month in last year's first quarter.

Retail sales were also stronger than expected in the first quarter despite severe weather and the caution still reflected in the major gauges of consumer confidence. The pickup was most pronounced at the high end where the wealth effect of the stock market rally has had a greater impact and where unemployment is only about one-fourth the rate of lower income groups. Spending by less affluent consumers is being supported by government transfer payments as growth in wages remains anemic and unemployment high. Consumer spending in the first quarter GDP report appears on track to increase as much as twice the depressed rate of 1.7% recorded in the fourth quarter.

Going forward, as support from fiscal policy begins to fade, increases in consumer spending, which still accounts for some 70% of GDP, will depend primarily on jobs and wage income. Abundant credit, including home equity loans on inflated home values, once made it possible for consumers to spend well beyond their incomes. In the aftermath of the financial crisis, credit is less available and more expensive. As the recovery matures, consumer spending is unlikely to grow much faster than income and is unlikely to be the engine of growth it was in the two decades preceding the crisis.

In 2010, we expect to see equity returns driven by proven performance as opposed to hopeful expectations of "better times."

With corporate profits growing some 30% year over year, business spending is a more likely candidate to lead a self-reinforcing expansion. During the recession, companies not only slashed payrolls but also liquidated inventories and curtailed capital expenditures. Nominal capex for equipment and software was still a depressed 6.4% of GDP in the fourth quarter. A rebound in investment approaching the prior peak of 10% of GDP reached a decade ago could be a significant driver of growth, particularly when accompanied by inventory rebuilding. Business spending will never be a full substitute for consumer spending in the GDP accounts, but it can reverberate throughout the economy and support consumer spending by creating jobs. Furthermore, increased business investment can make American firms more competitive in the global marketplace. Longer term economic rebalancing will likely require US businesses to rely less on selling to American consumers and more on selling abroad.

Near-term economic prospects are supported by numerous cyclical forces: unused fiscal stimulus, a favorable inventory cycle, strong corporate profits, pent-up demand for capex, improving labor markets and still accommodative monetary policy. US leading economic indicators are at their highest levels since 1983. Nonetheless, the recovery is still fragile and could be undermined by a further surge in commodity prices, a policy misstep or unforeseen external shock. The unprecedented size of policy stimulus heightens the uncertainty as policymakers must now unwind emergency measures and plan for raising rates. Emergency rescue measures have resulted in huge budget deficits, and officials are coming under increased pressure to outline credible plans for fiscal improvement. Meanwhile, the political environment has grown more difficult. There is increased public antagonism towards bankers and bailed-out managements and a palpable distrust of elected officials.

After a steep sell-off from mid-January through early February, the S&P 500 Index recovered and ended the first quarter higher. This advance marks the benchmark's fourth consecutive quarterly gain but still leaves the Index some 26% below its pre-recession peak. The vigorous rally in March was generally led by smaller, lower quality and more cyclical issues. The portfolio, which emphasizes high quality, stable global businesses, also extended its gains but trailed the Index in March and the first quarter.

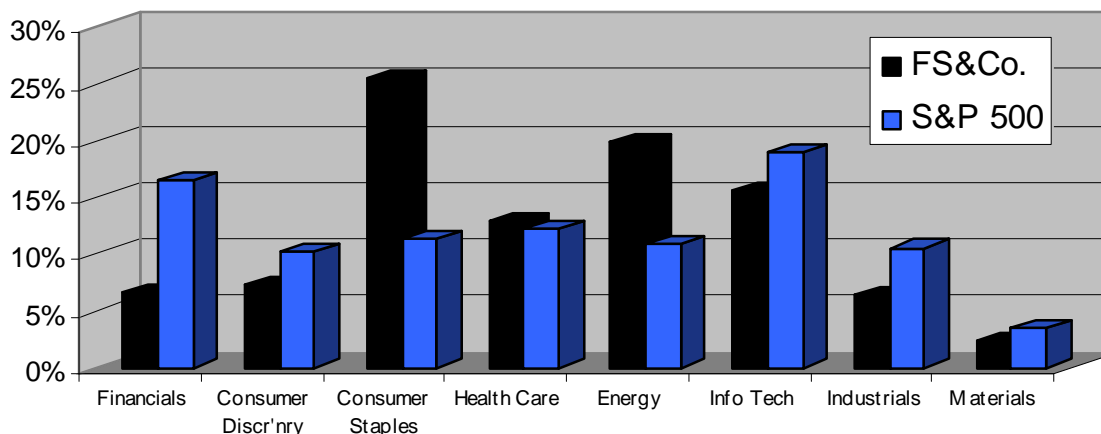
Relative performance was penalized by the limited and selective exposure in financials, a leading sector despite the prospect of increased regulation and greater restraints on future profits. Underweighted allocations to two other leading sectors—industrials and consumer discretionary—also hampered relative results. The significant overweighting of the energy sector was likewise an impediment. Factors that added value versus the Index included the limited and correctly focused representation in the underperforming technology sector. Holdings such as Apple and Intel outperformed industry peers and the market. The consumer staples sector modestly outperformed in the period, and the portfolio benefited from its significant emphasis on this sector. The underweighted allocation to utilities and the void in telecom also supported relative results. These sectors were the only ones that declined. Leading portfolio issues for the period included Estee Lauder, Novo Nordisk, Prudential Financial, General Electric, Bank of America, Intuitive Surgical and General Dynamics.

The global economic recovery, led by emerging markets, continues to strengthen. The March payroll report provides important evidence of continued, if gradual, improvement in the US. As capital markets anticipate the transition from liquidity-driven economic recovery to sustained expansion and discount the eventual withdrawal of policy support, the ability of high quality, self-funding multinationals to grow market share and sustain superior earnings growth should be more highly prized by investors.

<u>Top Ten Holdings*</u>
Exxon Mobil Corp.
Philip Morris Intl Inc.
Coca-Cola
Procter & Gamble
Johnson & Johnson
Nestle Sponsored ADR
Chevron Corp.
Apple Inc.
PepsiCo Inc.
Intel Corporation

<u>Portfolio Characteristics*</u>	
Avg. # of Holdings:	50-70
Avg. Mkt. Cap:	\$120 B
Median Mkt. Cap:	\$69 B
5-Yr. EPS Growth:	10.2%
Dividend Yield:	2.5%
P/E (2010E):	13.9x
ROE:	29.1%
Debt to Total Cap:	27.3%

Sector Weightings

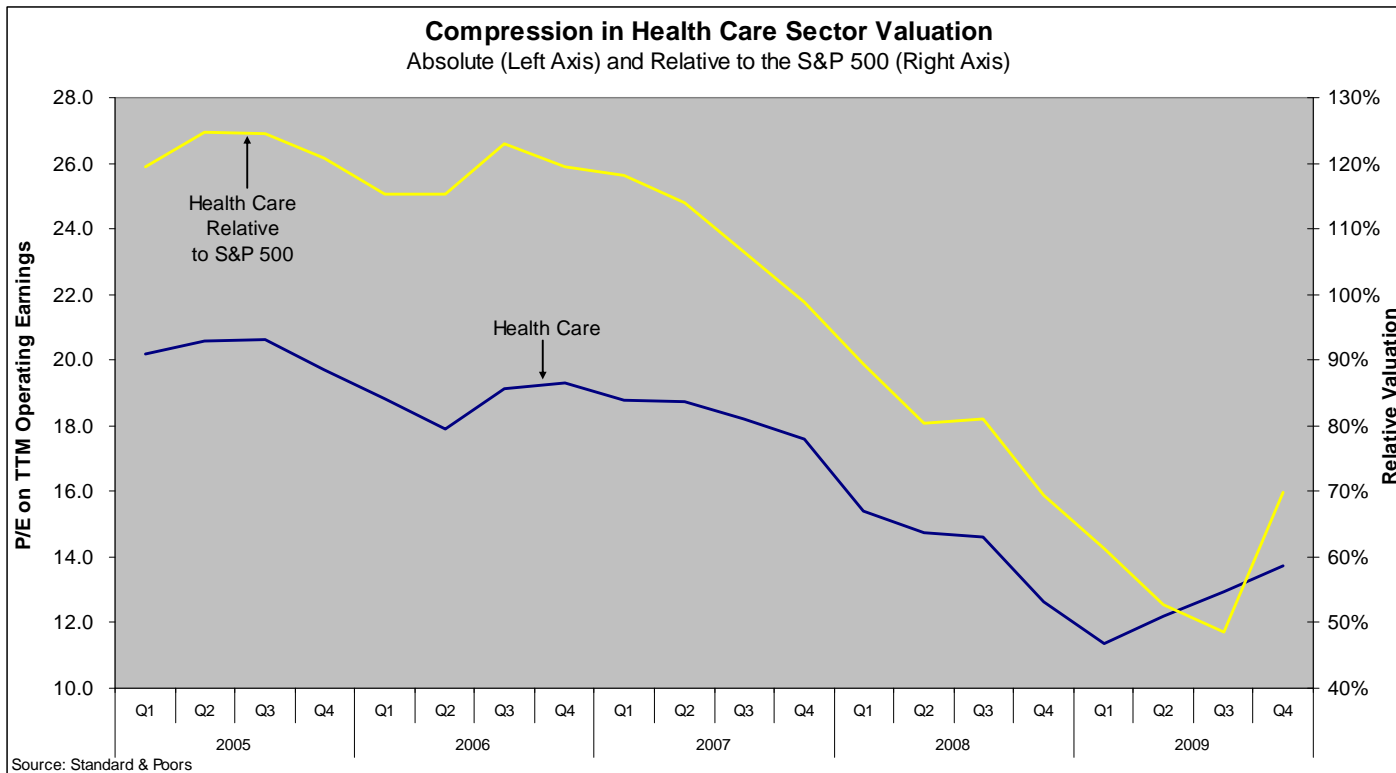


**Based on a target model portfolio. The specific securities identified and described herein do not represent all of the securities purchased, sold or recommended for the portfolio, and it should not be assumed that investments in the securities identified were or will be profitable. We will, upon request, furnish a listing of all investments made during the prior one-year period. Data as March 31, 2010.

HEALTH CARE SECTOR OVERVIEW*

By Rey Reza and Dan Connally

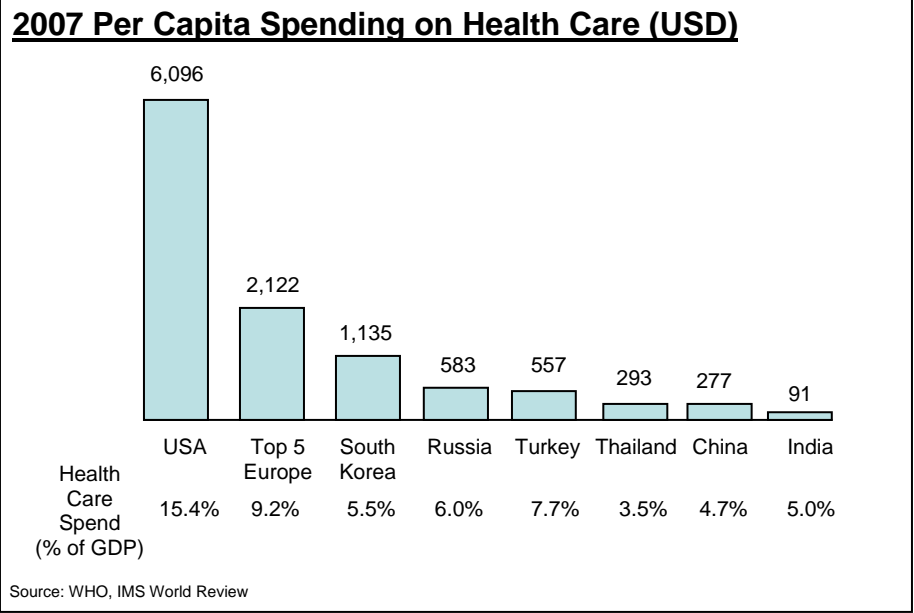
For much of the past decade, the health care industry has faced structural challenge due to patent expirations, lawsuits, lower pipeline productivity, regulation and broad concerns about government intervention. Generally speaking, these negative factors restricted the industry's revenue and profit growth while pressuring the sector's valuation and driving a multi-year period of corporate consolidation, as certain companies sought to bridge the gap in pipeline productivity with several years of expense rationalization following merger activity. However, with the recent passage of the domestic health care reform bill providing incremental clarity for the industry's operating structure, we believe the current environment presents an opportunity to access above average growth at very attractive valuations.



At FS & Co., we recognize there are challenges to avoid, but we believe the sector remains attractive for long-term investment given global growth in health care utilization and reasonable company-specific valuations, as a number of our investments trade at meaningful discounts to the S&P 500 despite what we view as unique growth opportunities. Globally, health care utilization continues to increase at an attractive rate due to durable underlying trends such as worldwide population growth, longer life expectancy and further income growth in developing nations like China and India. In the developed world, demand growth and a relatively stable global pricing environment have resulted in health care spending rising faster than overall GDP for an extended period of time. Consequently, health care spending now accounts for 10%-16% of GDP in many of the world's developed nations, compared to 4%-8% of GDP in many developing nations. The difference largely reflects the evolution of these economies, as well as the sizeable growth opportunities likely to materialize in developing nations as their economies mature.

At the upper end of the aforementioned range, the situation is particularly intense in the United States, where clinical innovation (drugs, devices, diagnostics, procedures, protocols) and rising expectations have combined with a system governed by perverse incentives to generate over \$2 trillion annually in health care spending, which is substantially more than predicted when compared to other developed countries and more than twice as much as the country spends on basic food. The discrepancy in health care resource allocation is even more substantial on a per capita basis, with the United States spending over 20 times more than China and over 65 times more than India. This discrepancy comes from both greater incidence of medical conditions as well as higher payment per episode of care, as our domestic health care system generally produces greater utilization (and ultimately greater total cost) at each step of the supply chain.

*The views expressed herein are those of Fayed Sarofim & Co.'s investment professionals at the time the comments were made and may not be reflective of their current opinions and are subject to change without prior notice. Neither the information contained herein nor any opinion expressed shall be construed to constitute investment advice or an offer to sell or a solicitation of an offer to buy any securities mentioned herein.



While these discrepancies have persisted for decades, we expect this gap in health care spending per capita to narrow over our investment horizon, with market dynamics and fiscal challenges ultimately acting as a gentle governor on the rate of spending growth in the developed world, particularly in the second half of the next decade. In the developing world, however, economic growth and the rise of the middle class are likely to drive the continued development of health care infrastructure, which should lead to broader coverage, improved access, higher utilization and greater per capita spending. Moreover, the globalization of certain cultural traits is likely to increase the incidence of obesity, which would have a cascading impact throughout the developing world as it will lead to higher rates of chronic medical conditions like diabetes, hypertension and arthritis.

Domestically, the health care reform discussions that dominated the headlines for most of 2009 and early 2010 broadly address coverage and access issues, not solutions related to lowering the unit or total costs of health care delivery. Several of the more onerous concepts – like a legitimate public option for health insurance, Medicare-for-all, predetermined price controls or rationing of care – did not materialize in the final bill, as the entire health care industry actively participated in this bill’s negotiations. The Pharmaceutical industry agreed to the largest concessions (\$80 billion over 10 years, less than 3% of annual industry revenue) in the form of subsidies, fees and rebates, but the net impact should be positive as higher utilization more than offsets incremental costs. Thus, despite the Obama administration’s best efforts, we do not expect the bill in its current form to restrict the health care spending growth rate over the next decade. Conversely, many of the taxes and fees that are being levied on health care industry participants are likely to work their way through the system in the form of higher prices for products, services and insurance premiums, which will exacerbate the current problem associated with the unit cost of health care. As a result, we believe domestic health care spending will remain at an elevated level for the foreseeable future as over 30 million previously uninsured citizens enter and remain in the health care system; clearly, this situation will create opportunities for manufacturers and providers throughout the health care supply chain. We expect that companies with clinically differentiated products will maintain pricing power. Looking out beyond the next decade, though, given the obvious fiscal challenges associated with growth in Medicare and Medicaid, as well as expansion of new programs like heavily-subsidized, state-based insurance exchanges, we believe the focus will shift to addressing the unit cost of health care, which is likely to come from a variety of mechanisms and present new challenges and opportunities for the industry. By the next decade, the domestic health care delivery system could become more standardized with less variability in treatment regimens, such that unique benefits accrue to those companies that can discover, develop and commercialize truly innovative and medically necessary products.

The foundation of our health care strategy is to invest in companies with demonstrated excellence in science and clinical innovation, as we believe that innovators will continue to be rewarded for breakthrough products with greater demand and more favorable pricing. We continue to advocate owning diversified companies with established excellence in researching, developing and commercializing new products in areas of high unmet medical need, including traditional categories like diabetes, oncology and immunology, as well as newer opportunities like minimally invasive surgery and customized approaches to disease management. We believe global distribution will continue to be of increasing importance. We advocate owning companies with large existing international businesses to offset what is likely to be a potentially challenging domestic system over the next ten years, particularly in the second half of the next decade as regulators and managers adjust to the realities of the domestic health care reform package.

Abbott Labs and Johnson & Johnson are less likely than their peers to be negatively impacted by patent expiration in the next five years. We continue to own Merck, Roche and Johnson & Johnson based on their ongoing commitment

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to science and clinical innovation; these companies routinely invest and commercialize new products at a rate far We remain attracted to certain companies in the Pharmaceutical sector – especially at recent valuations – given that several of the world’s largest and best biotechnology firms now reside inside these increasingly diversified companies. Our selective exposure in the sector benefits from a very favorable patent profile, as Novo Nordisk, greater than their peers. Additionally, we have expanded our health care holdings in recent years to include several Health Care Equipment firms, including Intuitive Surgical, Becton Dickinson and Medtronic. These companies possess market leadership positions in attractive categories; derive large and growing portions of their revenue and profits from overseas; produce sizeable operating cash flow; benefit from low ongoing capital intensity; and, continue to demonstrate maturity in regards to capital allocation and financial management. Historically, these companies have developed largely as domestic firms, but through organic expansion and external business development, they have expanded operations globally to include a strong presence in many large and rapidly-growing overseas markets. We continue to avoid Health Care Facilities due to their high fixed cost structure, outsized financial leverage and lack of global growth opportunities. We prefer to own high quality companies focusing in attractive markets and geographies, with quality measured by financial returns, low leverage and recurring cash dividend payments, as these companies should have opportunities in the coming years to capture market share and reinvest in their businesses.

ECONOMIC COMMENT (CONT’ D.)*

At Fayez Sarofim & Co., we believe the next decade will present both challenges to avoid and opportunities to capitalize upon. We see a market environment well suited for active management which can avoid pitfalls, yet identify and leverage select opportunities for growth. The US economic recovery will likely be characterized by high unemployment, a deleveraging consumer and a constrained credit environment. Global competition and overcapacity create an environment of weak pricing power and emphasis on cost cutting. The specter of higher taxes and increased regulation act as further headwinds to growth and investment going forward. With economic slack and high levels of debt on one side and extreme government stimulus on the other, prospects for both deflation or inflation are concerning. However, on the positive side, globalization provides US-domiciled multinationals access to higher growth outside our borders. Financially strong companies not dependent on credit markets will enjoy first mover advantages to make acquisitions or fund R&D or expand globally. Skilled management teams with a shareholder orientation can guide cash back to investors to optimize total return in a lower growth environment. In 2010, we expect to see returns driven by proven performance as opposed to hopeful expectations of “better times.”

The companies in our portfolio possess critical advantages in this challenging environment. They source over 60% of profits outside the US, leveraging faster growth when it is available outside our country’s borders. With a debt/total capitalization ratio nearly half that of the S&P500, our portfolio possesses the financial strength to grow without relying on the whims of bankers and capital markets. Our firm’s heritage of in-depth fundamental research leads to stock selection of companies with pricing power, sustained competitive advantages and strong management teams. Income characteristics of the portfolio remain strong and with the portfolio’s payout ratio around 34%, we maintain a high level of confidence in our companies’ ability to continue growing dividends at attractive rates. In addition to the attributes listed above, the valuation of the firm’s portfolio remains attractive, if not compelling, trading at a discount to the S&P 500, while at the same time offering exposure to high growth, financially strong, quality companies that also offer liquidity and attractive income characteristics. As the market enters an environment where quality is likely to be more highly valued, we believe the Fayez Sarofim & Co. portfolio is well positioned to lead the market in a continued advance while also providing downside protection in the event of a market setback.

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