Fayez Sarofim & Co.
Investment Counsellors

A Consistent Discipline for Over Fifty Years | June 2011

Mid-Year 2011 Outlook

In spite of considerable consternation surrounding the state of the global economy, European sovereign debt issues, and turmoil in the Middle East, financial markets finished the first half of 2011 with modest gains. The Standard & Poor's 500 Index registered a total return of 6.0% for the six-month period while the Barclays Capital Government/Credit Index of fixed income securities produced a 2.6% return over the same time period. Virtually all of the return for the S&P 500 came in the first quarter before concerns about economic growth resurfaced. And, almost all of the return for the bond index came in the second quarter along with those concerns. The Fayez Sarofim & Co. Equity Fund Composite produced superior results while focusing on financially-strong, industry-leading companies. In fact, our composite has returned over 33% in the past twelve months, beating the S&P 500 by almost three percentage points. Although market gains may slow down relative to that pace, we expect growth in profits, dividends, and attractive valuations to provide a solid foundation for future results.

Unquestionably, recent events remind us all that there are considerable risks in today's investment environment. Some of these risks are residual effects of the recent financial crisis and "Great Recession," including excessive overall levels of indebtedness and precarious government finances. Other risks are more exogenous in nature, like the earthquake and tsunami in Japan and political upheaval in the Middle East, which has contributed to a significant rise in oil prices. Policies designed to combat the economy's malaise are also coming to an end. The Federal Reserve's "QE2" program has run its course, and the federal government is currently negotiating a deficit reduction plan that will reduce government spending and potentially raise taxes. Recent employment gains have been dismal, leading to a 9.2% unemployment rate that remains abnormally high and is probably understated. All of these factors make investors anxious.

The main reason for our belief in continued positive investment returns is the potent combination of our companies' strong profits and balance sheets, wise redeployment of cash flow, and low valuations. We continue to see plenty of evidence supporting these critical pieces of our investment framework. Broadly, we estimate profits for the S&P 500 should set a new record in 2011 at a level now projected to approach $885 billion, which represents 17% growth over 2010 levels and is approximately $50 billion higher than what was expected at the first of the year. Companies continue to run their operations extremely tightly as a result of the uncertainty in the business environment. In addition, global sourcing and the abundant supply of labor—the largest line item in most companies' cost structure—have mitigated the impact of rising commodity prices. As a result, growing revenues continue to translate into much faster growth in profits. Our companies are participating fully in this environment as we currently expect them to deliver a 24% increase in profits in 2011, ahead of the 17% increase for the S&P 500.

Healthy earnings gains and strong balance sheets continue to afford management teams the flexibility to redeploy cash flow in dividends, stock buybacks, and acquisitions. So far in 2011, more than half of the companies in our portfolios have announced increases in their dividend. These dividend increases have improved the annual dividend income of a typical client portfolio by over 9% just since the beginning of the year. Importantly, rising earnings and low payout ratios suggest that these dividend increases should continue. Combined with a current dividend yield greater than the market average, our portfolios' faster-growing dividend streams represent a very attractive feature, especially in an era of extremely low interest rates. Also, our companies are taking advantage of current opportunities to repurchase their shares or make

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PORTFOLIO COMMENTARY

2nd Quarter Attribution*

As the second quarter progressed, optimism about the global economic recovery gave way to worries about a renewed slowdown in the US and an intensified debt crisis in Europe. The S&P 500, which peaked in late April and then sustained a six-week decline through mid-June, partially recovered in the final weeks to end the quarter essentially unchanged. The portfolio performed significantly ahead of the benchmark for the three months supported by the positive net impact of both stock selection and sector emphasis. The portfolio's substantially overweighted exposure to consumer staples, one of the strongest sectors, was a primary contributor. Holdings such as Kraft Foods, Nestle and PepsiCo logged double-digit returns in the quarter. Comparative returns also benefited from the significantly underweighted representation in financials, which continued to be pressured by legal and regulatory concerns as well as nervousness about Greek debt woes. Stock selection among technology, health care and materials issues was noticeably strong and added to the outperformance. After being the top sector in the first quarter, the energy sector lagged as oil prices retreated. However, the major integrated oils held in the portfolio performed better than industry peers and mitigated the negative impact of the sector overweight. Factors that detracted from relative performance included weakness in select holdings in the consumer discretionary sector as well as the lack of exposure in telecom and utilities, two small sectors that outperformed. Leading stocks in the portfolio in addition to those already mentioned included Roche Holdings, American Express, Johnson and Johnson, McDonald's, Intuitive Surgical, Intel, Estee Lauder and Becton Dickinson. Economic uncertainty remains high. While select forward-looking data suggest a second-half rebound, the debate about the strength of underlying trends may not be resolved soon. The firm's fundamental strategy and emphasis on sustainable earnings and dividend growth should prove advantageous in a market that is likely to demand patience and discipline.

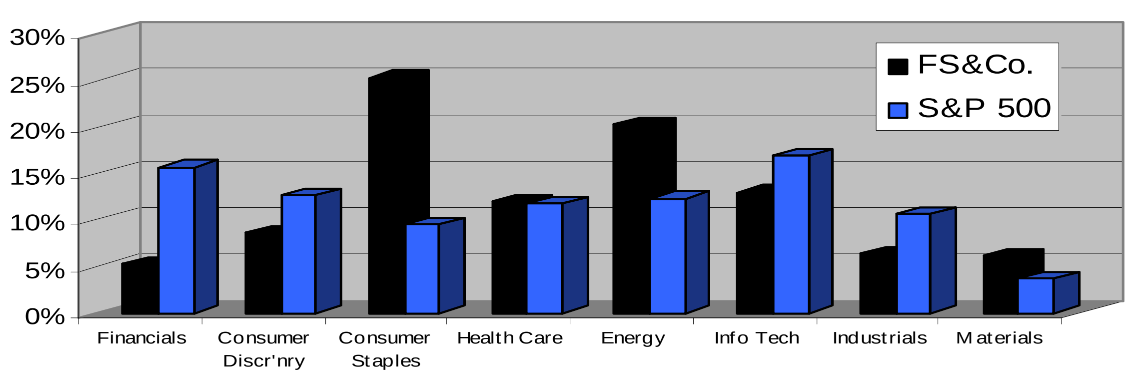
Top Ten Holdings*

Exxon Mobil Corp.
Philip Morris Intl Inc.
Coca-Cola
Chevron Corp.
Apple Inc.
Johnson & Johnson
Procter & Gamble
Nestle Sponsored ADR
McDonald's
Altria Group

Portfolio Characteristics*

Avg. # of Holdings:	50-70
Avg. Mkt. Cap:	$133 B
Median Mkt. Cap:	$82 B
5-Yr. EPS Growth:	10.1%
Dividend Yield:	2.6%
P/E (2011E):	12.4x
ROE:	35.3%
Debt to Total Cap:	29.9%

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 June 30, 2011.*

value-enhancing acquisitions when they deem it more attractive to buy rather than build a business. Considering the wide spread between the cost of financing and the high earnings yields driven by low valuation levels, share repurchases and acquisitions can be highly accretive. The willingness of many acquirers to pay significant premiums also indicates that they recognize value in the marketplace today.

While our portfolios have appreciated in value through the first half of 2011, our portfolio company valuations have actually declined overall as earnings rose faster than the stock prices. Our typical portfolio is trading at 12.4 times its expected 2011 earnings, approximately a 10% discount to the S&P 500, despite holding companies that offer faster growth, stronger balance sheets, higher levels of profitability, and more disciplined capital allocation. That price-earnings multiple still represents one of the lowest levels that our portfolios have exhibited since the 1980s, when inflation and interest rates were much higher than today. Clearly, anxious investors have discounted stock prices for many of the "macro" concerns dominating today's headlines. Many of the world's most dominant, profitable, and respected companies are available for purchase at prices that would imply their future prospects are bleak. Of course, we completely disagree with the market's assessment.

With share prices low, some management teams are also beginning to consider other strategies for creating value for shareholders. For example, ConocoPhillips has just announced a plan to split up the company by spinning off the refining and marketing division of the company. This decision reflects a view that the market is undervaluing the business overall and that the sum of the parts will be worth more than the current value in the marketplace. Low equity valuations, liquid balance sheets, and low-cost debt financing will support increasing amounts of these actions.

Living with the anxieties in the current investment climate is difficult, but investor concerns seem adequately reflected in the valuations of large capitalization stocks today. Therefore, our portfolios are positioned to capture an investment opportunity as the stock market climbs the proverbial "wall of worry." Moreover, our investment philosophy often outperforms in times when investors judge risk to be an important part of their investment calculations.

Considering the state of the world today and the length of time it will take to heal our economic wounds, we believe investors will be frequently reminded of the importance of managing risk, making our firm's strategy even more relevant and appropriate than it would be normally. These considerations build additional confidence in our ability to generate superior performance for our clients by investing in a set of businesses that simultaneously offers the prospect of superior wealth creation and the ability to reduce risk in difficult times.

FOR MORE INFORMATION ON FAYEZ SAROFIM & CO., PLEASE CONTACT:

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