



FAYEZ SAROFIM & CO.

Investment Counsellors

A Consistent Discipline for Over Fifty Years

3RD QUARTER 2010

LETTER TO INVESTORS

Financial markets produced solid gains in the third quarter, encouraged by improved economic releases and the growing likelihood of additional monetary stimulus provided by the Federal Reserve. During the quarter the S&P 500 equity index returned 11.3% while the Barclays Government/Credit Bond Index returned 3.3%. In addition, during this time of strong market performance, investors continued to favor higher quality investments, helping our portfolios produce strong results.

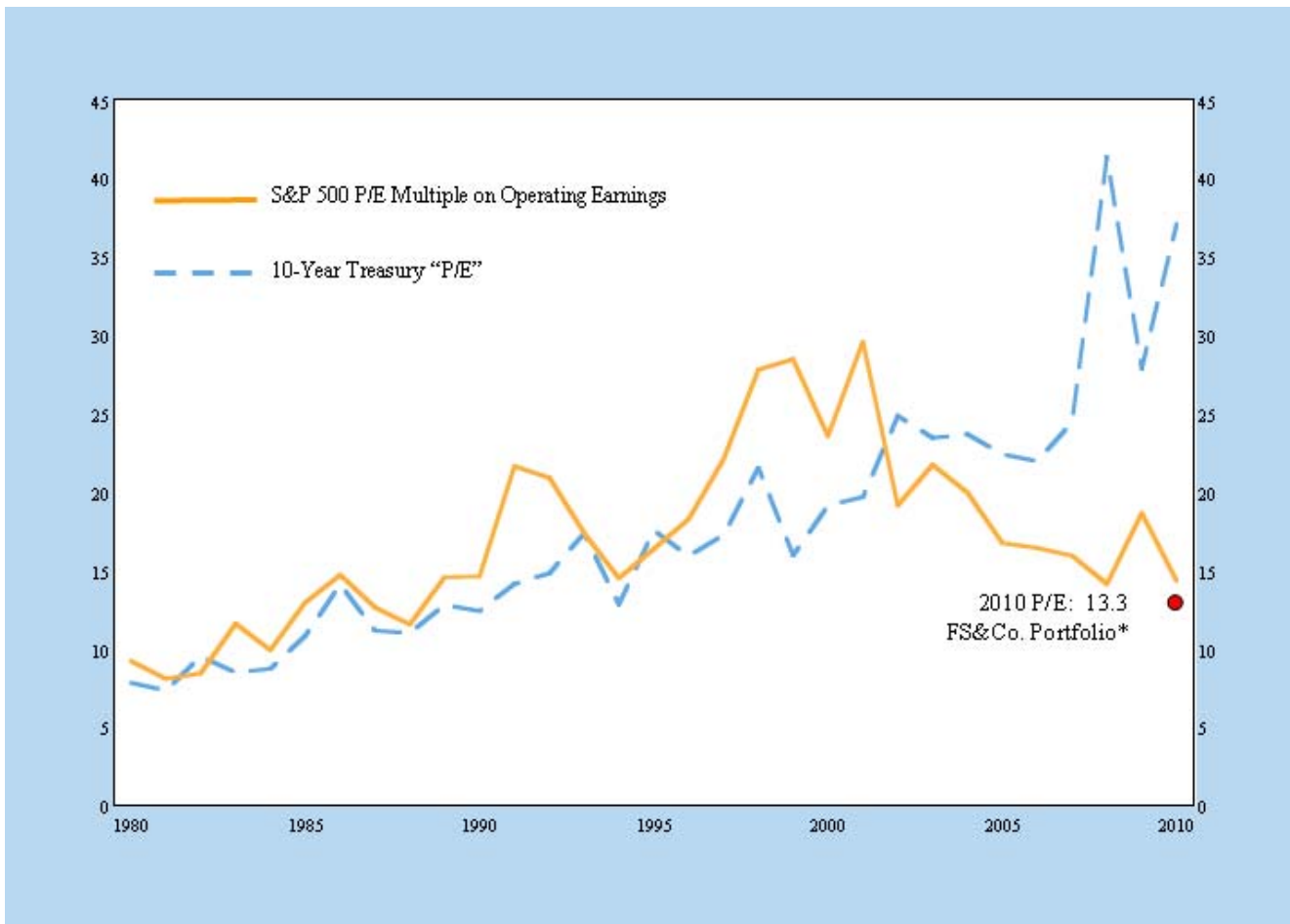
In our last letter we noted that investors had withdrawn money from US stock mutual funds for three consecutive years in response to the recent financial crisis and one of the most challenging decades on record for equities. According to statistics from the Investment Company Institute, the period from the beginning of 2008 through the end of the third quarter of this year witnessed a withdrawal of \$256 billion from domestic equity mutual funds and an inflow of \$651 billion into bond funds. Today, partly as a result of these massive flows, we believe that stocks—particularly of financially strong, industry-leading companies—are priced attractively and offer a much more compelling opportunity for long-term investors than fixed income securities. Furthermore, given current interest rates, dividend yields, and expected dividend growth, we believe that many of the companies in our portfolios may be better income investments than bonds over the coming decade.

In order to analyze the relative attractiveness of equities versus fixed income instruments, it is helpful to compare them using a similar metric. Most investors are familiar with the price-earnings (P/E) ratio, so our example will utilize that ratio. Equity valuations have moved up slightly since last quarter, but they remain at levels that we consider attractive. The yellow line on the following graph charts the current P/E and the P/E prevailing at the end of each of the past 30 years. At the end of September, the S&P 500 was valued at approximately 14 times expected 2010 earnings, reflecting a valuation level more common in the late 1980s and seen only infrequently since then.

For our “bond P/E” we have used the inverse of the yield of the 10-year Treasury bond. Like the P/E multiple of a stock, this figure represents the amount that an investor would have to pay to acquire a dollar of earnings. However, while we expect corporate earnings to increase over time, the “earnings” of a typical bond are contractually fixed for the term of the bond. Given the long-term decline in interest rates since 1980, the bond P/E has risen over time to almost 40 times earnings (a 2.5% yield) at the end of the third quarter. Investors have not paid this much for a 10-year Treasury’s earnings stream since the Eisenhower administration—1954 to be exact. And, while the chart indicates that a spread opened up in favor of Treasuries in the late 1990s, today’s spread favors equities and appears more extreme. It is also worth noting that fixed income investors suffered negative returns for twenty years after 1954.¹

¹ Source – Morningstar, Ibbotson, FS&Co. analysis

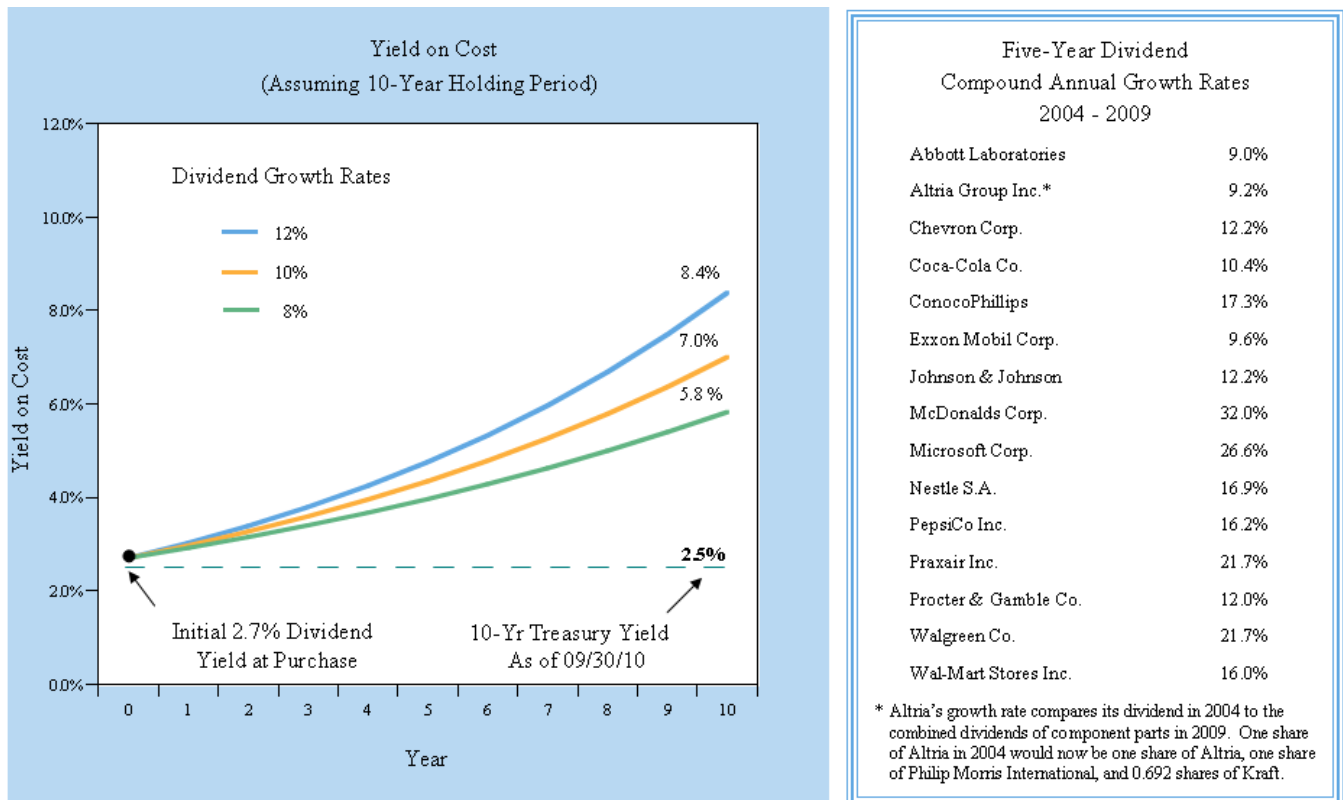
Chart 1 – Equities appear attractively valued, especially compared to fixed income.



* Based on a target model portfolio that may not be identical to every client account

Of course, most companies pay out only a portion of their earnings in dividends, so equity investors do not receive their entire share of the company's profits as current income. However, supported by a set of companies that generate high levels of profitability, superior earnings growth, and healthy cash returns for shareholders, a typical Sarofim portfolio currently yields more than the 10-year Treasury and offers the prospect of solid dividend growth. The following chart demonstrates the potential power of this growing dividend stream compared to investing in the Treasury bond, represented by the dashed line. In the chart, we have depicted how the yield on cost of an equity portfolio would change over time given different assumptions for the portfolio's dividend growth rate. Each line begins at a yield of 2.7%, which approximates the current dividend yield of one of our portfolios. The lower line illustrates an 8% dividend growth rate, while the middle and upper lines represent 10% and 12% dividend growth, respectively. At the end of a ten-year period of time, this analysis suggests that the yield on original cost for portfolios with these rates of dividend increases would grow to between 5.8% and 8.4%. Of course, the Treasury bond yield on cost would remain constant at 2.5% for the entire time period. On the right side of the graph, we have listed a number of our existing holdings and their five-year compound annual dividend growth rates.

Chart 2 – The power of a growing dividend.



The historical example of some of our portfolio holdings provides additional testimony to the power of this phenomenon. A company that can grow earnings and dividends at attractive rates over long periods can build an incredible income stream. For example, over a period of almost 40 years—from the end of 1970 to today—Procter & Gamble has raised its dividend consistently to the point that its current annual dividend of \$1.92 per share is greater than its split-adjusted price of \$1.80 on December 31, 1970. If an investor had purchased P&G shares on that day and held them since that time, his yield on cost is now 107%. Having done the same with Exxon, Chevron, and Coca-Cola would have produced yield-on-cost figures of 78%, 85%, and 100%, respectively. Philip Morris shares would have produced an eye-popping 758% yield on cost! In an era when the New York Stock Exchange's annual trading volume exceeds the total number of shares outstanding of its listed companies, we understand that a very small percentage of the investment community focuses on time frames longer than several years. Yet, our institutional and individual clients are investing predominantly to attain long-term goals, and harnessing the power of compounding is essential for meeting those objectives. Given the record low levels of interest rates today and the Federal Reserve's stated commitment to maintain those low rates for an extended period, investors have extra incentive to seek out long-term dividend growth.

Equity investing is considered more risky than investing in fixed income since equity returns are more volatile. At the same time, our unique situation today might cause some to rethink this conventional wisdom. Certainly, the relative valuations of stocks and bonds suggest a lower margin for error for bonds. Given the lengths to which the Federal Reserve and the US government are willing to go to stimulate the economy, it is quite possible that inflation could rise, maybe markedly, in the years to come. Such a scenario could be ruinous for bonds and the dollar while companies with pricing power, global income streams, and commodity exposures should be a much better inflation hedge. A typical Sarofim portfolio sources over 50% of its earnings from outside the US and includes a large commitment to the energy sector. At the same

time, our portfolios are also comprised of leadership companies with very strong balance sheets, providing protection against deflationary forces that could potentially reassert themselves.

At Fayez Sarofim & Co., we remain confident in our investment approach and optimistic about the long-term prospects for the economy and our investments. Fortunately, corporate profits are rebounding, the equity market is recovering lost ground, and investors seem to be regaining a greater appreciation for the positive attributes of our portfolio holdings. With global leadership positions, financial strength, superior capital redeployment, and attractive income characteristics, our portfolio companies are well positioned for the current environment.

Before we conclude, we wanted to take the opportunity to update you on some changes we have made to strengthen the firm's leadership and organizational structure. These changes are also an important part of our efforts to plan for management succession over time. Christopher Sarofim, who serves as President of Sarofim International, our subsidiary that provides investment management for foreign clients and oversees the firm's own capital base, has taken on the additional position of Vice Chairman of Faye Sarofim & Co. We promoted Gentry Lee, who has led the development of the firm's strategy in investment, client service, and business operations as Chief Operating Officer, to the position of President of Faye Sarofim & Co. We also promoted Jeff Jacobs, who has been responsible for organizing and overseeing our research activities and Investment Committee meetings as our Director of Investments, to Senior Vice President of Faye Sarofim & Co. Although their titles have changed, Christopher, Gentry and Jeff will continue to perform the same leadership duties they have been performing for the past several years. Under my supervision as Chairman, these individuals are directing the activities of our firm today, and with these changes, our firm is well prepared to maintain continuity in our business and investment operations in the future.

At Faye Sarofim & Co., we always consider our investments and our actions very carefully before entering into them. We expect that you would be surprised if the firm made wholesale changes to our investment team or to our investment portfolios. These organizational changes are deliberate, evolutionary steps that we believe are in the best long-term interest of our clients and our talented team of 22 investment professionals. We sincerely appreciate the confidence that our clients and business partners place in our firm everyday, and we believe that we have built an organization that will build on that trust for years to come.

As always, we are available and eager to answer any questions you may have.

The views expressed herein are those of Faye 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.

PORTFOLIO COMMENTARY

3rd Quarter Attribution*

Although economic and political uncertainty continued to riddle equity markets in the third quarter, economic data improved as the period progressed and fears of a double-dip recession receded. The S&P 500 Index, buoyed by vigorous rallies in July and September, registered a double-digit gain and reversed the losses of the June period. Strength was broadly distributed; seven of the ten economic sectors of the Index exceeded the composite return. The portfolio

PORTFOLIO COMMENTARY (CONT'D)*

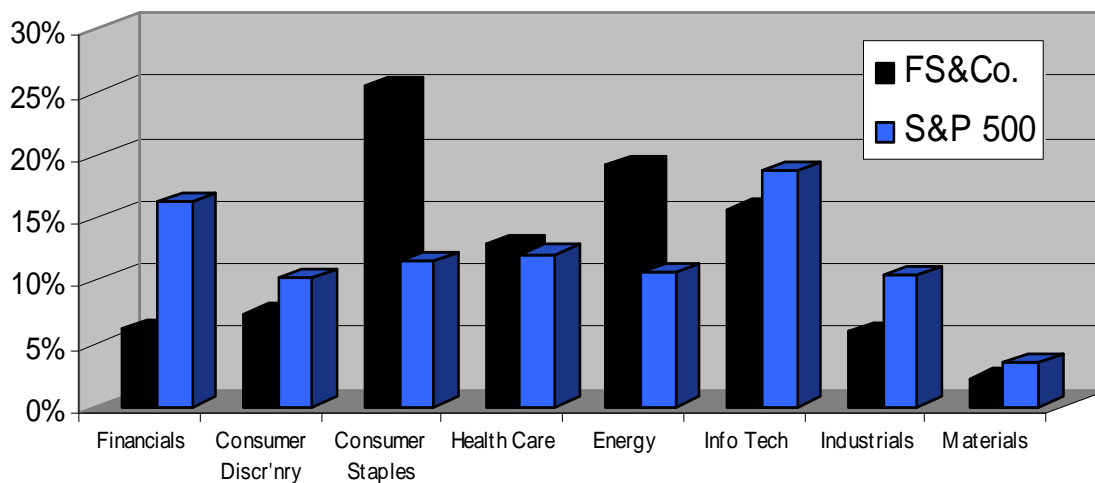
performed ahead of the benchmark for the three months and year to date. The focus on high quality, dividend-paying, industry leaders across the portfolio supported relative results in the quarter. Stock selection was particularly beneficial in consumer staples, energy, financials and materials. The net impact of sector allocation was essentially neutral. The underweighting of financials, the weakest sector in the quarter, and the pronounced emphasis on energy added value relative to the Index, but this was largely offset by the underweighted exposure to several cyclical sectors and the void in telecommunications, the top performing sector. Leading issues in the portfolio included Freeport-McMoRan, Qualcomm, Halliburton, Caterpillar, Walgreen, Peabody Energy, Franklin Resources and Philip Morris International. As the impact of fiscal stimulus and inventory rebuilding wanes and constraints from private sector deleveraging and contraction in the banking system persist, the recovery will continue to face significant headwinds. In the context of subpar US growth and continued global expansion, investors should be well served by maintaining a longer term perspective and a focus on companies with stable, internationally diversified earnings streams and a record of increasing dividend payments.

Top Ten Holdings*

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

Portfolio Characteristics*

Avg. # of Holdings: 50-70
 Avg. Mkt. Cap: \$117 B
 Median Mkt. Cap: \$66 B
 5-Yr. EPS Growth: 10.6%
 Dividend Yield: 2.7%
 P/E (2010E): 13.3x
 ROE: 27.8%
 Debt to Total Cap: 29.5%



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

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*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 September 30, 2010.