FAYEZ SAROFIM & CO.

Investment Counsellors

A Consistent Discipline for Over Fifty Years | 4TH QUARTER 2010

LETTER TO INVESTORS

Supported by growing confidence in the economy, the stock market enjoyed a strong finish in 2010. A fourth quarter return of 10.7% for the S&P 500 brought the index's full year return to 15.1%. Therefore, despite the fear exhibited by the market in the second quarter, 2010 marked another year of progress toward recovering losses suffered by investors during the recent financial crisis. Portfolios managed by Fayez Sarofim & Co. participated nicely in the market's advance, especially after investors recalibrated their expectations regarding the speed of the economic recovery during the second quarter. Importantly, we believe that our portfolios—filled with financially strong, industry-leading companies—will generate superior returns for our clients in future years as well.

In our last client letter, we suggested that stocks were priced attractively and offered a more compelling opportunity for long-term investors than fixed income securities. While that suggestion was clearly a statement on expected long-term returns from that starting point, the fourth quarter witnessed two important developments that corroborate our thesis. First, fixed income markets lost a little ground in the quarter, with the Barclays Government/Credit Bond Index falling 2.2%, representing the first quarterly decline over 2% since 2004. Second, mutual fund flows reversed as equities attracted net inflows, and more significantly, bond funds shifted from monthly net inflows averaging $27.9 billion from July through October to growing net outflows in November and December. With an improving economy, strong corporate profits and balance sheets, and attractive equity valuations, our long-term outlook calls for continued outperformance by equities.

Many observers have recently pointed out that economic recoveries following financial crises tend to be slower and more difficult than during a normal business cycle. However, extreme fiscal and monetary stimulus continues to support the US economy. Announced in early November, the Federal Reserve's "QE2" program of quantitative easing—$600 billion of additional purchases of US Treasury bonds—is an important component of its plan to enhance economic growth. So far, the Fed's willingness to pursue QE2 has convinced investors and business leaders that it will do what it takes to support the economy, thereby building confidence and lifting expectations for future growth. Aided by low interest rates and improved confidence, the capital markets continue to function more smoothly and offer greater availability and lower cost of financing to the economy. According to Thomson Reuters, corporations issued just over $1 trillion in debt in the US during 2010, up almost 13% from 2009. In particular, high yield offerings increased 85% to $273 billion. On the equity side, data from Dealogic—a firm that tracks investment banking activity levels—indicate that initial public offerings raised $38.5 billion, up 130% from 2009. The strong recovery in these more risky categories suggests that capital is definitely flowing more freely into the economy. In addition to the developments in financial markets, changing political dynamics should also now support the recovery. Feeling that President Obama and the Democratic Congress had overreached their mandate, voters delivered a rebuke of historic proportions in the midterm elections. Subsequent to the election, the administration has demonstrated that it received the message. Its hostile attitude toward business seems to be easing, and President Obama reached an agreement with Congress to extend the Bush tax cuts for all tax brackets for another two years.

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PORTFOLIO COMMENTARY

4th Quarter Attribution*

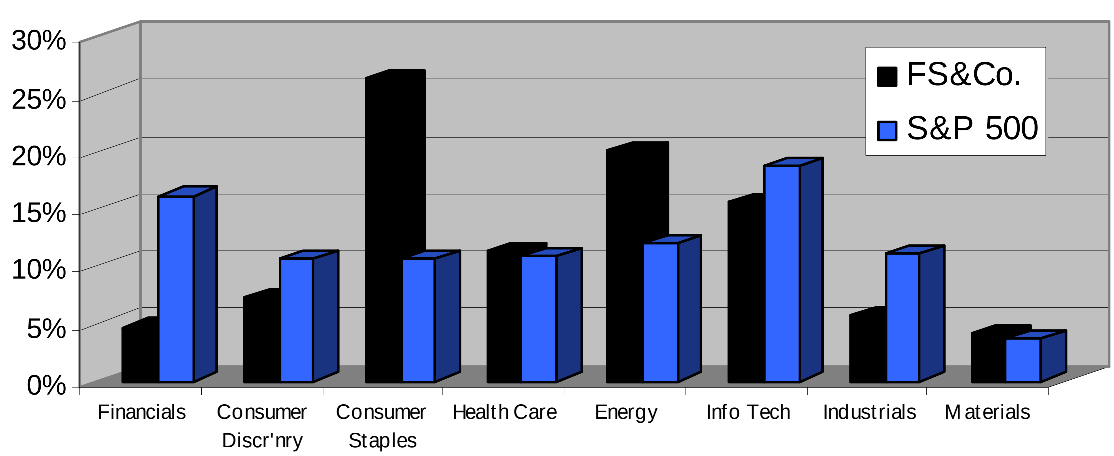
US equity markets ended 2010 on a strong note. Amid growing optimism that the fragile economic recovery would be sustained, the S&P 500 achieved a high for the year on December 29th and registered a double-digit gain in the fourth quarter. The portfolio exceeded the S&P 500's robust gain for the full year, but a lagging performance in December, when smaller, riskier issues outperformed, led to results that modestly trailed the index in the fourth quarter. The net effect of sector allocation supported relative results in the quarter. Crude oil prices rose some 14 percent in the period, helping to make energy the quarter's best performing sector. The portfolio benefited from its substantially overweighted energy position as well as from its lack of exposure to the underperforming telecommunications and utilities sectors. Stock selection among industrial and technology issues also supported relative results. Factors that detracted from relative performance included the high quality focus among financials, our emphasis on less cyclical companies in the consumer discretionary sector, and the overweighting of consumer staples. Top-performing portfolio holdings in the fourth quarter included Freeport McMoRan, Schlumberger, Estee Lauder, Occidental Petroleum, Halliburton, Rio Tinto, Texas Instruments, and Caterpillar. Fundamental distinctions are expected to play a larger role in determining individual stock price performance in 2011. The industry-leading companies in the portfolio are well-equipped to extend earnings gains and enhance shareholder value through significant dividend increases, stepped-up share repurchases, and discerning capital redeployment.

Top Ten Holdings*

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

Portfolio Characteristics*

Avg. # of Holdings:	50-70
Avg. Mkt. Cap:	$128 B
Median Mkt. Cap:	$74 B
5-Yr. EPS Growth:	10.5%
Dividend Yield:	2.5%
P/E (2010E):	14.6x
ROE:	27.4%
Debt to Total Cap:	29.1%



**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 December 31, 2010.*

Given that some business leaders were afraid to commit to investing or hiring decisions during an era of uncertainty around rapidly-changing government policies and regulatory frameworks, greater certainty and confidence should facilitate greater corporate spending and employment.

Even in this subdued recovery following the financial crisis, corporate profitability has been surprisingly robust. As we have mentioned previously, corporate restructuring and cuts to capital and operating expenditures resulted in significant operating leverage and a rapid rebound in profits. Many sectors of the economy experienced a resumption in demand this past year, leading to sales growth for the companies in the S&P 500 of approximately 6%. Continuing improvement in the global economy should drive similar growth in 2011. Once the numbers are available, we expect 2010 S&P 500 operating earnings will total approximately $740 billion, an increase of 47% from 2009. Non-financial earnings will set a new record in 2010, and with financial earnings now benefitting from falling credit losses, we also expect overall S&P 500 earnings to set a new record in 2011 at a level over $830 billion. Balance sheets also remain pristine as a result of management conservatism. The combination of commercial and industrial loans and commercial paper outstanding has declined by $1 trillion over the past two years. Cash on the balance sheet of nonfinancial companies in the S&P 500 stands at over $900 billion, up $250 billion since the end of 2008. Within a typical Sarofim portfolio, the ten largest holdings are essentially debt-free. Their total debt of approximately $140 billion is offset by cash and liquid investments of a similar amount. And, to further illustrate their financial strength and flexibility, we expect those ten companies to report combined earnings over $120 billion in 2010.

Healthy earnings gains and strong balance sheets suggest that management teams will increase the rate at which they are redeploying cash flow in dividends, stock buybacks, and acquisitions. Rising dividend payments were an important component of our argument in our last letter for equity exposure over low-yielding fixed income instruments. Nineteen of our twenty largest holdings pay a dividend, and seventeen of those twenty increased their dividend in 2010 by an average of 12%. The other two dividend payers that did not raise their dividend in 2010 are already paying generous dividends. As further proof that companies should be increasing their cash returns to shareholders, the S&P 500 Index's dividend payout ratio of 24.5% in 2010 is the lowest on record in the history of the index, which began in 1926. In addition to dividend payments, stock repurchases undertaken at current valuation levels are also highly likely to create value for shareholders.

Our final argument for our portfolio's return prospects centers on valuation. While earnings should surpass former peak levels this year, the S&P 500 remains 18% below its former peak. Our typical portfolio is trading at less than thirteen times its expected 2011 earnings, a slight discount to the S&P 500, despite holding companies that offer a potent combination of faster growth, stronger balance sheets, higher levels of profitability, and more disciplined capital allocation. That price-earnings multiple represents one of the lowest levels that our portfolios have exhibited since the 1980s, when inflation and interest rates were much higher than today.

Managing risk is obviously an important part of portfolio management, and before we conclude this letter, it is worth noting that there are still sizable risks present in the investment landscape. Some of these risks are ones with which the investment community has very limited or infrequent experience, including worries about the soundness of the financial system, the limits of sound monetary policy, the creditworthiness of cities, states, and sovereign nations, and the functioning of markets in periods of regulatory and technological change. Excessive levels of debt caused most of the trauma associated with the recent financial crisis, and that leverage problem has not been cured. It takes years of restraint to repair balance sheets, especially ones laden with hundreds of billions or trillions of debt. Therefore, we expect that the investment community will endure some unpleasant surprises from time to time, which further argues for pursuing an investment strategy like ours that relies on superior businesses to generate returns and to protect from risk. We remain optimistic about the prospects for our investments and for our firm in this type of environment, and we are eager to serve our clients to the best of our ability as we invest alongside them.

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