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# A Balanced Approach

## Up - down — sideways

Over the last nine months broad market averages have produced two significant rallies and two significant corrections of the magnitude of 10 to 15% each. Comparing stock prices from June 30th, 2010, to levels at September 30th, 2009, one could conclude that not much has changed. However with the increased volatility, nothing could be farther from the truth.

The vigorous market rallies were fueled by improving economic activity, better credit trends, growth in corporate profits and the expectations of stabilizing employment. The significant corrections have been induced by concerns of a spreading sovereign debt crisis in Europe, a deceleration of emerging market economies (specifically China), improving domestic economic trends being viewed as transitory and growing concerns over increased debt, taxes and regulation from Washington. After approaching 18-month highs in stock prices in late April, the quarter ended at nine-month lows, producing a 15% correction over the last 9 weeks of the quarter.

Domestic economic trends definitely stalled as we approached summer. The home buyers tax credit expired on April 30th and housing activity fell in May and June. This was not a surprise; however, other consumer spending trends (retail sales and auto sales) showed signs of decelerating as well. Employment trends showed improvement, but not as rapidly as some had forecast. Business capital spending continued to be strong, but financial markets began pricing in a slower pace of economic activity in May. Fears of a “double-dip” recession have increased of late, but these concerns may already be somewhat reflected in stock valuations given the recent decline in both stock prices and interest rates.

Our underlying economic outlook has not changed. We expected a mid-year deceleration in economic activity, unemployment levels to remain stubbornly high and corporate profits and margins to be better than expected. In April, we were concerned that interest rates and inflation concerns could heat up sooner (if the domestic economy didn’t slow down); however, the European debt crisis and the deceleration of the Chinese economy have relieved those pressures, most likely for the remainder of 2010. In two months the discussion has shifted from whether the Federal Reserve should raise interest rates to head off pending inflation, to more calls for additional stimulus to avoid falling back into recession. This shift allows the U.S. Fed to keep interest rates lower for a longer period of time, which will allow for continued improvement in our banking system and real estate market while avoiding the echo recession or double dip that concerns investors.

While interest rates and stock prices have come full circle over the last nine months, corporate profits and balance sheets continue to show signs of strengthening. The banking system and the auto industry have made dramatic changes benefiting from the government support and extremely low interest rates. Non-financial U.S. corporations are carrying record high levels of cash and low levels of debt. Cash balances represent over 7% of total corporate assets. This position is a symbol of strength and conservatism. Based upon the lack of clarity in the future (economic, interest rates, taxes and regulation) this posture is appropriate until more certainty is achieved and will offer a source of strategic opportunity in the future. We expect strong balance sheets to lead to increased dividends, share repurchases, acquisitions and other shareholder friendly activities.

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## Arcataur Capital Management LLC

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**Arcataur Large Capitalization Equity Portfolio** - This portfolio offers investors a separately managed account consisting of high quality, blue chip stocks. Our strategy focuses on maximizing expected return through constructing diverse portfolios covering most major industry sectors. On average, this portfolio could hold 55 stocks; however, the largest 15 could account for as much as 45% of the portfolio.

**Arcataur Investment Grade Fixed Income Portfolio** - This portfolio offers investors a separately managed account focusing on Treasuries, Agencies, corporate bonds and municipal bonds, with an average portfolio credit rating of AA or better. Our approach is to actively manage interest rate risk and credit risk while minimizing liquidity risk to generate conservative risk-adjusted total return.

**Arcataur Managed Balance Portfolio** - This portfolio offers investors a separately managed account which seeks to preserve capital during difficult market periods while allowing growth opportunity in good market conditions. Arcataur has developed a model that assists us in determining the relative attractiveness of stocks versus bonds. When our models and fundamental analysis indicate stocks are more attractive, we will be near our upper end of the range for stocks (75%). Conversely, when bonds are favored, we will be near the lower end of the stated range for stocks (45%).

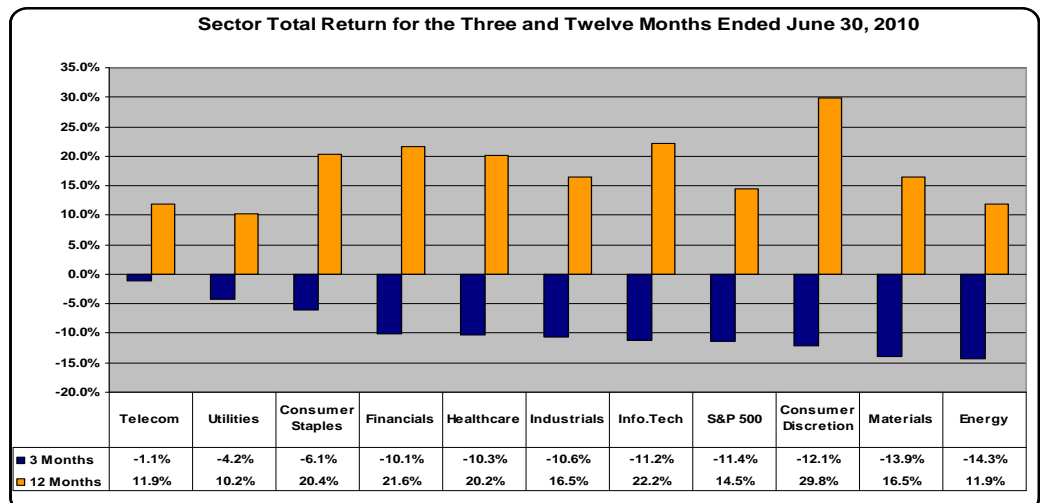
## Up – down— sideways (continued)

Corporate profits for the second quarter will be reported in mid-to-late July. We expect continued strength in margins, cash flow and bottom line earnings. Given that revenues have increased while hiring and other costs have lagged, this should translate into higher profitability. We expect future outlook commentary to be conservative, especially for any company that sells to consumers. This conservative posture may unnerve investors; however, we believe it is appropriate for current conditions.

Financial regulation reform is expected to become law in July. Once it is completed, we would expect a less active legislative agenda for the remainder of the summer. The fall mid-term elections will be a focus for investors. Recent election results have raised the prospects of an anti-incumbent bias. Any shifts could have a profound impact on how the political agenda may evolve. The one aspect that financial regulation reform did not address was the government-sponsored mortgage agencies (Fannie Mae and Freddie Mac). If meaningful consideration is not given to the eventual restructuring or unwinding of these entities, we would anticipate implications expressed via the markets by the purchasers of our government and agency debt, in the form of higher interest rates required by investors. All things considered, addressing the mortgage agencies would be easier while interest rates remain relatively low.

The announcement in mid-June that China was more open to a market-based currency was initially received positively by investors world-wide; however, the lack of details on the process quickly reduced the enthusiasm. China's stock market continues to be one of the weakest performers, as it has under-performed the U.S. broad averages by more than 10% over the last year. After a volatile quarter, broad equity averages ended the second quarter at the lows. The S&P 500 (total return) was down 11.4% for the quarter and -6.6% for year-to-date. The smaller capitalization (illustrated by the S&P 600 Small Cap Index) issues were down by 8.7% for the quarter, the NASDAQ Composite was down 9.4%, and the Dow Jones Industrial Average was down 9.4% on a total return basis for the second quarter.

Sector performance reflects the increasing concerns of a slowing economy. The under-performance of the economically sensitive sectors of consumer discretionary, materials and energy indicates that they were eschewed in favor of the more staid groups of telecom, utilities and consumer staples. The intra-quarter volatility of the sectors was significant as well. For the foreseeable future we would expect market and sector volatility to remain elevated. The chart below illustrates how all the sectors performed in the quarter and for the trailing twelve months.

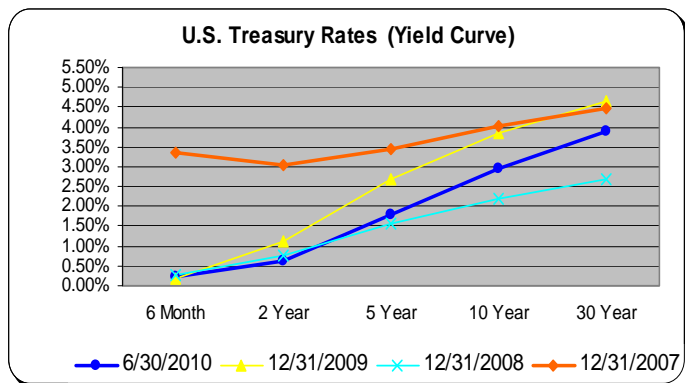


Source: Baseline

## Safety trade - redux

The ten-year Treasury bond yield rose to 4% in early April (bond prices decline as yields rise) before increasing fears of a Greek debt default sparked the start of a flight-to-quality rally focused on German Government and U.S. Treasury bonds. Interest rates and bond yields moved down the remainder of the 2<sup>nd</sup> quarter as additional sovereign debt worries, slower growth in China, weaker U.S. economic data, and lower inflation expectations dominated investors' outlook. By quarter end the 10-year Treasury yield closed at 2.93%, down 90 basis points (0.90%), a level not seen since April 2009. Two-year Treasury note yields fell to record lows. Investors are again risk averse and looking for the return of their money, not a return on their money.

As European Union member countries discussed austerity measures to deal with high debt levels, expectations for slower global growth caused economists to lower their inflation estimates and push out the timing for the Federal Reserve to begin raising interest rates from late 2010 to the second half of 2011. The latest Fed meeting minutes also acknowledged slower economic growth ahead, as well as lower underlying inflation. Those minutes again included language that rates would remain "exceptionally low" for an "extended period" of time.

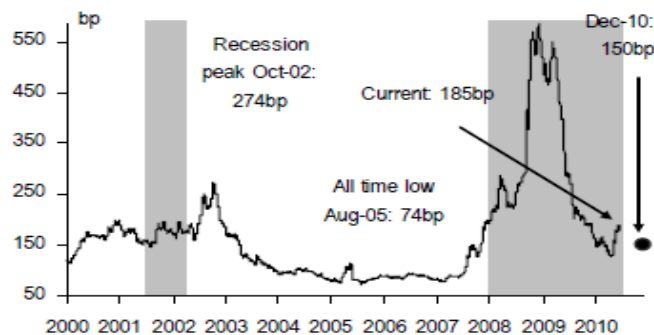


Source: Baseline

Investment grade corporate bond spreads (premium over treasury bond yields) have realized a modest widening (larger premium) as investors became more risk averse. Spreads remain fairly narrow on a historical basis as investors search for reasonable yields. Quality corporate bonds offer the best way to improve yield, without assuming significant risk. Despite yields being at ten-year lows, demand for corporate bonds remains high and demand exceeds the new issue supply. Inventories of corporate bonds with dealers and at the brokerage houses are sparse. It is difficult to find issues that meet our criteria for price, quality and yield, so we have remained selective to not over pay in this environment. Corporate financial position continues to strengthen as cash balances remain high, revenue generation improves and debt levels decline. We remain overweight corporate bonds versus our internal benchmark.

The strength of corporate balance sheets and the overall low level of interest rates are also illustrated by the number of call notices we are receiving. Corporate treasurers are calling in (redeeming bonds prior to maturity) higher coupon debt and either not replacing it or replacing it with lower coupon debt with longer maturities, thus locking in lower interest expenses. We are experiencing an even more rapid pace of bond calls in the government agency segment.

**Exhibit 1: High grade bond spreads are attractive at current levels**



Source: J.P. Morgan

Yields on government agency bonds (Fannie Mae and Freddie Mac) have essentially been reduced toward U.S. Treasury bond levels as they act as the primary mechanism to keep mortgage rates at such low levels. This melding of the agency and government bond markets has occurred under the conservatorship of the U.S. government. A more formal restructuring plan of these agencies is expected over the next twelve months.

The duration of our fixed income portfolios continues to be short (less than 2.5 years) as a result of the bond call activity and the lack of issues that meet our price, yield, and quality parameters. We have been very selective buying investment grade corporate bonds and callable agency debt. The investment grade portion of our portfolio remains diversified across market sectors and we avoid concentrations of exposure in any single company. Interest rates on FDIC-insured CDs and shorter duration treasury bonds are not attractive at current yields. Within the last six months we have increased our exposure to U.S. Treasury inflation-protected bonds (TIPS) as they offer slightly better yields and out-performance opportunities in both rising and falling rate environments. This increased exposure was in direct response to the diminishing opportunity and portfolio weight of government agency bonds.

Arcataur continues to focus on high quality bonds and the overall quality rating of the fixed income portfolio is mid-single A. We do not invest in mortgage-backed securities, high yield bonds or asset backed bonds.

## Third Quarter 2010 Investment Outlook

Despite the gut-wrenching market volatility and slower economic data recently, we believe stable growth (2.5%-3.5% GDP) is still achievable. We expect the potential deceleration to continue into the second half of 2010; however, this slightly more moderated pace will also slow the risk of inflation. The recent decline in stock prices and interest rates portend a much slower or even negative growth. Real income continues to grow, and the softening of consumer spending has correlated with the recent rise in the savings rate. This indicates more of a pause in economic activity after a vigorous response since the second quarter of 2009.

Stock prices are at similar levels to nine months ago; however, corporate profits have increased nearly 20% over the same period of time. In September 2009 the S&P 500 was trading at 1025, with earnings (trailing 12 months) of \$60. This equated to an overall price earnings ratio in excess of 17 times earnings. At the end of June 2010, with a similar price level as nine months earlier, the earnings power is \$72 per share or approximately 14 times earnings.

A conservative estimate of future earnings range is between \$75 to \$80 for calendar year 2010 and \$85 to \$90 in 2011. This would indicate a future market P/E in the range of 11 to 12 times. Based upon current economic statistics and historical parameters, this level of market valuation is overly pessimistic.

Stock prices rarely move up solely on the prospect of inexpensive valuation. Based upon current circumstances we expect continued volatility within a broad range of moves up and down, similar to what has been experienced over the last nine months. At the lower end of the range there are opportunities to exploit and at the upper end of the range investors need to reassess the risk they are willing to tolerate. A sustainable recovery for the domestic economy and for stock prices will not be realized until employment trends improve significantly and Washington makes serious moves toward fiscal discipline. We would expect improved opportunities for this to occur as we approach 2011.

A sustainable economic recovery could also mark the bottom in inflation and interest rates. We would expect that slack in the economy would narrow and the

Federal Reserve would start to raise interest rates. Currently we would expect this to be a first half of 2011 event at the earliest.

A stabilization in the European debt crisis and the Chinese economy will afford better capital flows. China and all of the emerging markets will be significant players for improved economic trends. The fall elections in our country will be important for determining the direction of fiscal policy and the result of aggressive regulatory moves taken over the last two years.

For our large capitalization direct portfolios, we have increased exposure to more economically sensitive sectors during the recent correction. As the economic expansion improves, these sectors have the leverage to out-perform the broader market.

Our high quality fixed income portfolio has offered stability and balance over the last 18 months. The current environment offers more challenges to find value and yield; as a result, a defensive and liquid posture is being maintained.

We have increased our equity exposure within our Managed Balance portfolios as stocks corrected. Our goal is to maintain an above average exposure to stocks, as valuations and relative attractiveness favor equities over fixed income investments.

## The Tax Man cometh?

President Obama was elected on a platform of lower taxes for the lower and middle income brackets and higher taxes for the more wealthy. Fast forward two and half years later, and now the focus is how to balance the need to stimulate growth while tackling elevated deficits. As the economy struggles to attain sustainable growth, an important question for policy makers is the direction of tax rates. The legislation implementing the Bush-era tax cuts of 2001 and 2003 mandates that those cuts expire at the end of 2010 unless Congress passes new legislation. Despite many attempts over the years, these cuts were never made permanent and the moment of truth is at hand. Without legislation, individuals will see their personal income tax brackets increase in 2011. The 10% bracket increases to 15%, the 25% bracket to 28%, 28% to 31%, 33% to 36%, and 35% to 39.6%. Furthermore, the capital gains tax will rise from a range of 0% to 15% to 20% and dividend income will increase from 15% to the individual's ordinary income tax rate (maximum of 39.6%). Additionally, the estate tax will be reinstated at 2002 levels which implies a 55% Federal tax rate with only a \$1MM exemption, the child tax credit will be reduced from \$1,000 to \$500 per child, the "marriage penalty" will return, a variety of tax credits will be reduced or eliminated, and the phase-out rule for itemized deductions and personal exemptions will return. A raft of provisions designed to stimulate primarily small business capital investment and hiring will expire as well. The obvious policy and economic question is whether the federal government should be significantly raising taxes at a time when the economy is attempting to find sound footings. Recently Treasury Secretary Geithner suggested a 20% cap on capital gains and dividend income. Markets reacted favorably to this less onerous proposal. We currently expect the Obama Administration will propose a compromise bill which will extend the Bush tax cuts for taxpayers with income below a certain threshold (\$150,000 to \$250,000) while allowing the cuts to expire and rates to rise for earners above the threshold. While the economic impact of these actions may be difficult to figure, what is certain is that this compromise will increase the complexity of the tax code.



## Arcataur Composite Investment Performance for the Three Months, Twelve Months and Three Years Ended June 30, 2010

Arcataur Composite Portfolio	Total Return 6/30/2010		
	3 Months	12 Months	3 Years Ann.
Large Cap Equity	-12.05%	11.29%	-10.28%
<b>Benchmarks</b>			
Lipper Large Cap Core	-12.30%	12.10%	-10.02%
S&P 500	-11.43%	14.44%	-9.81%
S&P 100	-12.10%	11.40%	-9.65%

Arcataur Composite Portfolio	Total Return 6/30/2010		
	3 Months	12 Months	3 Years Ann.
Fixed Income	1.48%	7.49%	5.86%
<b>Benchmarks</b>			
Citi BIG 1-5 (T/G/C)	1.79%	5.61%	6.11%
Citi BIG (T/G/C)	3.97%	9.78%	7.59%
Lipper Bond MF Avg.	1.80%	13.00%	4.91%

Arcataur Composite Portfolio	Total Return 6/30/2010		
	3 Months	12 Months	3 Years Ann.
Small Cap Equity	-8.84%	22.53%	-8.02%
International Equity	-14.56%	6.76%	-13.17%
Total Equity*	-11.56%	13.70%	-10.04%
<b>Benchmarks</b>			
Lipper Small Cap Core	-9.40%	21.60%	-9.03%
S&P 600	-8.73%	23.64%	-7.64%
EAFE	-14.91%	3.13%	-15.85%
S&P 500	-11.43%	14.44%	-9.81%

Arcataur Composite Portfolio	Total Return 6/30/2010		
	3 Months	12 Months	3 Years Ann.
Managed Balance	-7.81%	10.82%	-5.11%
<b>Benchmark</b>			
Lipper Balanced	-6.30%	12.70%	-3.46%

\*Total Equity is not an actual composite portfolio; rather, Total Equity represents a weighted average return of the Large Cap, Small Cap and International composites, and is only shown as an indication of potential overall equity performance. Total Equity does not represent any actual portfolio because it is made up of a weighted average return of all equity classes.

## Appendix: Disclosure Information Regarding Composite Performance

### General

Arcataur Capital Management LLC is a registered/licensed investment adviser. Arcataur has prepared this report. The information in this report has been developed internally and/or obtained from sources which Arcataur believes are reliable; however, Arcataur does not guarantee the accuracy, adequacy or completeness of such information nor do we guarantee the appropriateness of any strategy referred to for any particular investor. Index information has been taken from public sources. Past performance is not indicative of future results, as investment returns will vary from time to time depending upon market conditions and the composition of the composite portfolio. Returns for individual investors will vary based on factors such as the account type, market value, cash flows and fees.

### Calculation Methodology

Arcataur has generally prepared these composites in substantial compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPStm) in the calculation and presentation of investment performance composites, with one notable exception relating to the treatment of cash: cash is not included in the performance calculations for the Arcataur Large Capitalization Equity Portfolio Composite or the Arcataur Investment Grade Fixed Income Composite; Arcataur also does not allocate cash in the Arcataur Managed Balance Portfolio Composite to the equity or fixed income components when calculating performance for those components. Cash is, however, included in the overall performance calculation for the Arcataur Managed Balance Portfolio Composite. AIMR has not been involved in the preparation or review of this report. Arcataur is not claiming AIMR compliance.

The composites reflect dollar-weighted returns of individual accounts. Arcataur uses the AIMR recommended time-weighted internal rate of return formula (i.e., returns that include reinvested dividends and other income) to calculate performance for the accounts included in the composite. Individual account returns are calculated on a time-weighted basis, linked monthly, and include reinvestment of dividends and other such earnings. Total return (return) is defined as the percentage change in market value (including interest and dividend income) adjusted for any client-directed cash flows. A time-weighted, monthly-linked method is used to calculate composite calendar quarter returns. Quarterly returns, rounded to two decimal places, are geometrically-linked to calculate annual, cumulative and annualized returns. No leverage or derivatives have been used. Accounts are added to the composites when at least 70% of the account's value is invested in accordance with the client's investment plan and in accordance with the investment style chosen for the account. Terminated accounts are maintained in composites through the last full month assets are managed. Arcataur uses the accrual basis of accounting for the presentation of performance results, with the exception of the treatment of dividends - dividends are recorded when received. Portfolio return calculations and portfolio valuations are based on trade date settlement. (cont.)



## Appendix: Disclosure Information Regarding Composite Performance (cont.)

### Composites

The Arcataur Large Capitalization Equity Composite consists of portions of all client accounts invested in accordance with the Arcataur Large Capitalization Equity Portfolio strategy (including ETF's).

The Arcataur Small Capitalization Composite consists of portions of all client accounts invested in small capitalization equity securities (including ETF's).

The Arcataur International Composite consists of portions of all client accounts invested in international securities (including ETF's).

The Arcataur Investment Grade Fixed Income Composite consists of portions of all client accounts invested in accordance with the Arcataur Investment Grade Fixed Income strategy.

The Arcataur Managed Balance Composite consists of portions of all client accounts invested in accordance with the Arcataur Managed Balance strategy.

Mutual fund holdings are not included in composite results. Exchange traded funds are included in composite results. Mutual fund holdings typically are "unmanaged assets" and, therefore, are not included in composite results. Exchange traded funds are designated as "managed assets" and, therefore, are included in the composite results.

### Fees

Performance figures that are "net" of fees take into account investment advisory fees and any brokerage fees or commissions that have been deducted from the account. Performance figures that are "gross" of fees do not take into account investment advisory fees or transaction costs. For "gross" performance figures, actual returns will be reduced by expenses that may include management fees and transaction costs. A client's return is reduced by investment advisory fees and commissions, and any other expenses (such as custodial fees) that it incurs relative to its investment advisory account. Performance figures do not take into account federal or state income taxes. Arcataur's investment management fee schedule is included in Part II of the Form ADV. The Arcataur Large Cap, the Arcataur Small Cap, the Arcataur International, the Arcataur Investment Grade Fixed Income and the Arcataur Managed composites are net of fees. The S&P 500® Index, S&P® 100 Index, S&P 600® Index, the EAFE® index, the Citigroup Broad Investment Grade Index (T/G/C), and the Citigroup Broad Investment Grade Index (T/G/C)(1-5 Years) are gross of fees; the Lipper Large Cap Core, Small Cap Core, Balanced Fund and Bond Fund Averages are net of fees.

### Indices and Benchmark Funds

The Indices and Benchmark Funds are referred to for comparative purposes only and are not necessarily intended to parallel the risk or investment approach of the accounts included in the composites. Arcataur believes that the Indices and Benchmark Funds selected for comparative purposes are appropriate measures given the investment approach. However, the investment portfolios underlying the indices are different from the investment portfolios managed by Arcataur. The Indices and Benchmark Funds shown are unmanaged, and investors may not invest directly in them. The Indices and Benchmark Funds are considered to be generally representative, in terms of risk and exposure, of the various components as follows:

Arcataur Large Capitalization Equity Portfolio - the S&P 500® Index, the S&P 100® Index and Lipper Large-Cap Core Average

Arcataur Investment Grade Fixed Income Portfolio - the Citigroup Broad Investment Grade Index (T/G/C) and (1-5 Years) and the Lipper Bond Mutual Fund Average

Arcataur Managed Balance Portfolio - Lipper Balanced Fund Average

If a client's portfolio contains small cap exposure, the small cap performance is measured against the S&P 600® Index and Lipper Small Cap Core Average. If a client's portfolio contains international exposure, the performance is measured against the EAFE index.

With the exception of the Lipper Balanced Fund Average, the Lipper Large Cap Core Average, the Lipper Bond Mutual Fund Average and the Lipper Small Cap Core Average, indices and benchmark funds shown reflect the reinvestment of dividends and other earnings, but do not include transaction costs, management fees or other expenses of investing. For further information concerning the Index and Fund Benchmarks, ask to see Arcataur's Benchmark Descriptions.

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