

BERWYN SELECT MUTUAL FUND

S E R I E S

ECONOMIC BACKDROP

Adam Smith coined the term “invisible hand” in his 1776 book *Wealth of Nations*. The idea put forth is that, left to its own accord, a capitalist system will thrive and efficiently place goods and services in a way that is best for society. In certain instances, however, demand can be so seriously destroyed that, absent some stabilizing force, the economy can head into a tailspin. John Maynard Keynes argued that in such instances private demand should be supplemented with the “visible hand of government” to improve the health of the economy. While we will let the likes of Paul Krugman and Larry Kudlow argue the short-term merits of the visible versus invisible hand in promoting economic growth following the 2008 financial crisis, we can examine the after-effects of one of the government’s recent stimulus efforts (visible hand).

One of the more widely advertised programs has been the government’s aid to the housing market. With the home purchase tax credit, the government offered an \$8,000 credit (not to exceed 10% of the purchase price of the house) to first time home buyers. The original credit expired in November, 2009, but then was extended until April, 2010 (with closing completed by the end of June). The extension was also expanded to include existing homeowners trading up to larger homes.

BSMFS Second Quarter Top Performing Funds

	Sector	Qtr.	1 Year
EQUITY			
Perkins Small Cap Value	Small Cap Value	-6.40%	24.61%
Heartland Value Plus	Small Cap Value	-7.33%	24.11%
Artisan Small Cap Investor	Small Cap Growth	-7.77%	19.82%
FIXED INCOME			
Fidelity GNMA Fund	Mortgage-Backed	3.54%	9.01%
Vanguard GNMA	Mortgage-Backed	3.43%	8.30%
Am. Century GNMA	Mortgage-Backed	3.21%	8.21%

The apparent logic behind the credit was that since housing had suffered tremendously during the financial crisis and is a key component of the nation’s economic health, the country should take steps to revive the market. Some would say the government was supporting housing prices to protect its investment in Fannie Mae and Freddie Mac, the largest housing investors of all. Others would point to the historically strong Congressional lobbying and political contributions made by the National Association of Realtors and homebuilders as the impetus behind the program.

Regardless of the program’s rationale, its effects are now becoming clear. What the program did was to pull forward and temporarily inflate demand rather than create sustainable demand. The Census Bureau has shown that new home sales (which are reported when the contracts are signed) fell 32.7% in May compared to April. Existing home sales (which are reported upon closing) only declined 2.2% in May versus April.

While the official statistics for new home construction have not yet been released for June, some anecdotal evidence is already starting to come out that the month may have been particularly bad. During a conference call, the CEO of Lennar Homes said that home sales were down between 20% and 25% versus the same period last year. If this holds true for the industry, then the upcoming posting from the Census Bureau will show the worst June on record for new home sales. For existing home sales, the recently reported June figure showed continued weakness with a decline of 5.1% compared to May.

The conclusion is that, with the removal of government support, weakness has returned to the housing sector. Fortunately for the housing market, today’s low level of new homes being built will actually sow the seeds to eventual health by allowing the supply of new homes to gradually realign to existing demand. This may cause more hardship for the housing industry in the short term, but in the long run the invisible hand does work. One small bright spot for housing is that the general economic malaise has led to the lowest mortgage finance rates since the 1950’s.

2nd Quarter at a Glance

	Quarter	1 Year
DJIA	-9.36%	18.94%
S&P 500	-11.43%	14.43%
S&P 400	-9.59%	24.93%
Russell 2000	-9.92%	21.49%
BIG*	3.66%	9.03%
MLHY II**	-0.07%	27.53%
3 Mo. T Bill	0.04%	0.13%
MSCI EAFE***	-13.97%	5.92%

All numbers are total returns

* CitiGroup Broad Investment Grade Bond Index

** Merrill Lynch High Yield Master II Index

*** Morgan Stanley Capital International Europe Australasia and Far East (EAFE) Index

MARKET PERFORMANCE

Looking back at the quarter, there was no shortage of reasons for investor panic: the oil spill in the Gulf of Mexico created unknown consequences of an uncertain magnitude, the Greek debt crisis sparked the fear of credit contagion in Europe, and the “flash crash” raised questions about the market’s infrastructure. As a result, for the first time in five quarters, domestic equity markets closed the quarter lower than where they started it as presented in the table above. As has been the trend over the past year, small and mid-capitalization stocks outperformed larger companies, and value slightly outperformed growth. While no sector could escape the market’s wrath, more defensive sectors, such as Utilities, Telecommunications and Consumer Staples, were less impacted than cyclical areas like Materials and Energy. Financials were hit hard in the quarter in

light of the uncertainty of surrounding Congressional financial sector reform.

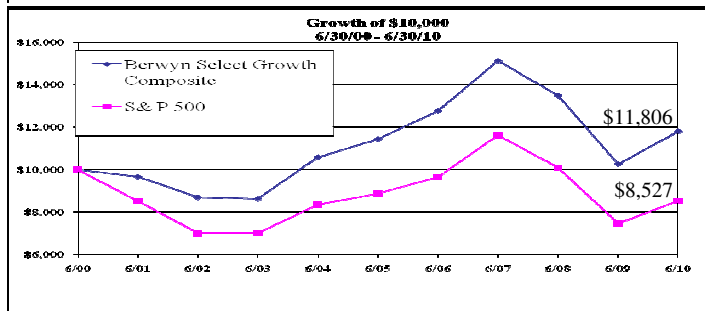
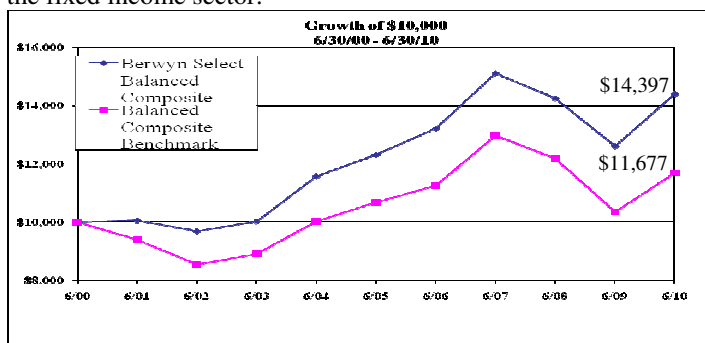
The debt crisis in Europe and questions surrounding slowing growth in China both contributed to international developed markets underperforming the United States' stock indices. The MSCI EAFE Index returned a negative 13.97% for the period. Hong Kong, Japan, and the United Kingdom were down the least in the quarter, while Greece, Spain and Italy lagged the most. The dollar strengthened against most foreign currencies (except the Japanese yen), hitting a four year high against the euro during the quarter.

Fixed income markets benefited from the volatility of the equity markets in the quarter, with the Citigroup Broad Investment Grade Index returning 3.66%. Investors sought out the safest assets, leading to significant gains in long-term Treasuries and forty year lows in mortgage rates despite the Federal Reserve ending its mortgage-backed securities repurchase program. At quarter's end, the rate on a 30-year fixed mortgage was just over 4.50%. Treasuries had their best performance since the fourth quarter of 2008 as the yield on the 10-year note fell below 3% for the first time since the equity markets bottomed in March 2009. Predictably, both investment-grade and high yield corporate bonds underperformed Treasuries as corporate bond spreads widened with investors avoiding riskier and less liquid assets.

PORTFOLIO CHANGES

The Committee did not make any individual mutual fund changes in the quarter, but did alter the allocation model. As the yields on Mortgage Backed Securities dropped to near all time lows, the Committee decided to reduce Berwyn Select's exposure to MBS, with the proceeds reallocated to large capitalization stocks.

At quarter end, accounts maintained a slight large and mid-capitalization bias over smaller companies in the equity portfolio, and have larger allocations in short and intermediate term bonds over high yield and mortgage backed securities in the fixed income sector.



In addition to showing Berwyn Select's Growth and Balanced Composites' returns for different time periods below, this quarter we are showing in graphical form how each composite has performed versus its benchmark index over the past ten years.

BSMFS PERFORMANCE

Periods Ended 6/30/10	BSMFS Growth Composite	S&P 500	BSMFS Balanced Composite	Balanced Benchmark*
1 Quarter	-10.50%	-11.43%	-6.49%	-6.26%
1 Year	15.07%	14.42%	14.21%	12.88%
3 Years	-7.94%	-9.81%	-1.57%	-3.46%
5 Years	0.64%	-0.79%	3.18%	1.80%
10 Years	1.67%	-1.58%	3.71%	1.56%
Inception to Date**	3.39%	-0.19%	4.68%	2.34%

* 65%-35% weighting of the S&P 500 and CitiGroup Broad Investment Grade Bond Index

** Inception to date, 10 year, 5 year and 3 year returns are annualized. Note: Inception: 4/1/99

Performance Footnotes:

Past performance is no guarantee of future performance.

The Growth Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is \$50,000 or greater at the beginning of the measurement period. The composite does not include equity segments of balanced accounts. The composite's inception date is April 1, 1999.

The Balanced Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is \$50,000 or greater at the beginning of the measurement period. The composite's inception date is April 1, 1999.

Both composites include no accounts holding mutual funds purchased by anyone other than the Advisor. No leverage or short positions are used in the accounts included in the composites. An individual client may have performed higher or lower than the composite returns listed above.

The composites presented herein represent non-taxable and taxable accounts. The returns are before taxes and are net of all advisory fees and commission charges. The composites may contain accounts having contracts with either The Killen Group or Berwyn Financial Services. Returns include the reinvestment of dividends and interest (total return). Returns for other BSMFS composites are available upon request.

As of 6/30/10, The Killen Group managed \$1.34 billion in assets, \$1.28 billion as advisor and \$57 million as sub-advisor. The Growth Composite above consisted of four accounts, which represented 7.3% of total Berwyn Select assets and 0.04% of total Killen Group assets. The Balanced Composite above consisted of fifteen accounts, which represented 40.6% of total Berwyn Select assets and 0.2% of total Killen Group assets.

Unless otherwise noted, all returns mentioned in the body of this newsletter are total returns.

MUTUAL FUND SERIES MANAGEMENT

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BSMFS is marketed by both Berwyn Financial Services and The Killen Group, Inc.

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