

**First Quarter 2011
Bond Market Review
and Outlook**



**Current Events &
Important Factors**

Two guys arguing over the bar bill on the Titanic

That is how my good friend, Harvey described the recent budget battle to reach an “historic” cut of \$38 billion from the \$1.05 trillion federal government spending bill for the remainder of this fiscal year. That’s a cut of 3.6% to a budget that is 7.3% more than last year’s. So we continue to spend more. The federal budget (total “outlays”) has risen from \$1.8 trillion in 2000 to \$3.8 trillion in 2011, up \$700 billion since 2009 and \$400 billion from last year (source: Congressional Budget Office). Quite a herculean effort that budget deal pressured by extremists! And the 2010 and 2011 reported outlays are reduced by banks’ repayment of funds advanced in the TARP bank bailout; so actual spending is even higher (source: CBO). The CBO’s baseline spending projections (based on current laws in force show increases every year reaching \$5.7 trillion in 2021 (a 50% increase from 2011’s budget). The nasty fighting over such a small amount in light of projections is a major factor in our decision to maintain a more conservative portfolio structure in terms of an entity’s financial metrics and industries populating the portfolios and maturity.

The U.S. corporate bond market continues to attract investors, who are driven to the sector by a preference for more conservative asset class allocations and strategies in light of these problematic budget trends and the absence of bipartisan proposals based on quantitative analysis. Also, yield spreads over Treasuries remain generous and the ultra-steep yield curve delivers a healthy yield increment for maturity extension. Therefore, demand for bonds remains strong. 2011 new issuance in High Yield at \$94 billion is 37% ahead of last year’s record setting volume. Investment Grade Corporate new issuance at \$154 billion remains robust but down 14% from 2010.

We forecast a continuation of these trends given the fragile economic expansion both in the U.S. and globally. Also investor age demographics are driving increasing allocations to more risk averse assets, such as bonds. This year will result in modest GDP growth driven by the payroll tax cut enacted in December and temporary tax rule allowing businesses to expense 100% of the cost of capital purchases. Both expire at year end. So GDP loses these stimulus sources in 2012.

Major factors impacting GDP, inflation and industry preference follow.

U.S. federal and state and local spending are #1. We have to borrow 37¢ of each \$1 of federal spending. So the debt is growing rapidly. Accumulated Federal debt as a % of GDP is now projected to reach the critical level of 90% of GDP by 2017 (CBO forecast 3/18/11). That is the level many economists including Carmen Reinhart (Peterson Institute) and Ken Rogoff (Harvard) consider a critical insolvency threshold. So reducing federal spending is a major necessity.

On the state & local level the spending is as bad. For FY 2012 starting in July, 44 states and DC are projecting deficits of \$112 Billion. In 2009 - 2011 state deficits totaled another \$430 Billion (Center for Budget & Policy Priorities 3/9/11). Many are heavily indebted: out-

(continues on page 3)

- “When Americans learn they can vote themselves money the republic is finished.” attributed to Ben Franklin.
- 47% of federal income tax filers pay no federal income tax. Top 1% of taxpayers (those with +\$380,000 in income) paid 38% of taxes (source: IRS)
- S&P puts negative credit rating outlook on U.S. Treasury AAA rated debt. Meaningful action required by 2013. IMF reports deficit reduction strategies in the U.S. lack credibility (4/11/11).
- Small business expectations worsen in April (NFIB April survey).
- Economists’ median forecast for GDP growth is 2.9% in 2011 and 3.1% in 2012. GDP was 2.9% in 2010.
- Portugal follows Ireland and Greece into the debt restructuring ICU. Spain downgraded by Moody’s 3/24/11. Debt problem Euro GDP growth forecast at just 1.7% in 2011 and 2012 (4/6/11)
- Japan’s reactor accident as severe as Chernobyl. Radiation, gulf oil spill or coal emissions. How to meet electric & energy demands?
- Commodity price shocks (oil) are now a new risk to economic expansion.

Yields to Maturity * on 3/31/11	YTM
CAM Broad Market (corporate core plus) Strategy (8.6 year maturity; 5.7 duration)	5.12%
CAM Investment Grade (100% corporate bonds) Strategy (7.8 yr maturity; 6.1 dur)	4.21%
CAM High-Yield Strategy (only BB & B rated purchased) (10.2 year mat; 5.0 dur)	6.85%
CAM Short Duration Strategy (4.7 year maturity; 3.1 duration, 50% IG & 50% HY)	4.34%
Tax Equivalent Muni GO Bond ** (7 yr. = 2.83%. Barclays Institutional Index.) To right shows after 40% tax equivalency & 3-point retail price mark-up for small buys under \$1 M)	4.58%
U.S. Treasury** (10 year maturity)	3.45%
U.S. Treasury ** (5 year maturity)	2.23%
3 Month Treasury Bill**	0.10%

* yield is to maturity or the “worst” call date, that producing the lower yield. ** Source: Barclays.

Contact us: Don Stolper, David Karpa & Bill Sloneker are always available to assist.
Phone: (513) 554-8500. Website: www.cambonds.com.
Email: dstolper@cambonds.com, dkarpa@cambonds.com, wsloneker@cambonds.com

CAM’s Key Strategic Elements

- Bottom-up credit analysis determines value and risk.
- Primary objective is preservation of capital.
- Larger, more liquid issues preferred.
- Target is always intermediate maturity.
- No interest rate forecasting.
- All clients benefit from institutional trading platform & multi-firm competitive bids & offers.



CAM returns are after CAM's average management fee & all transaction costs but before any broker, custody or consulting fees.

	IQ '11	1-YEAR	3-YEARS	10-YEARS
CAM Broad Market Strategy 1/3 high yield, 2/3 Investment grade	1.50%	9.24%	7.07%	6.12%
CAM High Yield "Upper Tier" Strategy only purchase BB & B no purchases of CCC & lower	3.09%	12.46%	8.68%	6.84%
Lipper High Yield Mutual Funds Average	3.66%	13.58%	9.63%	6.75%
CAM Investment Grade Strategy 100% corporate bonds	0.62%	7.85%	6.15%	5.91%
Lipper A-rated Bond Funds Average	0.84%	6.44%	5.76%	5.09%
CAM Short Duration Strategy 1/2 investment grade, 1/2 high yield 6/2004* start	1.76%	7.28%	5.77%	<u>5 years*</u> 5.62%

CAM claims compliance with Global Investment Performance Standards (GIPS ®) and such compliance has been verified by independent verifiers (Ashland Partners, PricewaterhouseCoopers & Deloitte & Touche) through December 31, 2009. Please call for a copy. Returns of Mutual Funds Averages are reported by Lipper Analytics. Mutual funds are referred to for informational purposes only; their composition is different from the composition of the accounts included in the performance shown above.

Performance Review 3/31/11

Our **Investment Grade Corporate Strategy (IG)** trailed the Barclays Corporate Index for the 3-months (0.69% vs. 0.86%) but outperformed the Index by 67 basis points for the twelve months. We trailed the Index for the 3-year period as Baa rated bonds significantly outperformed the Index (we are always underweighted that credit subsector) during 2009; however, we slightly exceeded or approximated the Index for the 5- and 10-year periods. Our 3 month performance was impacted by the strong performance of Baa rated bonds as well as the strong performance of the Bank and Finance Sector (this accounts for 34% of the Index and we do not exceed 30% exposure to any Sector). The **IG Strategy** ranked in the top half of the third quartile of the Gen-

eral Bond Intermediate Term peer group for the 3-months, at the top of the first quartile for the year, and in the bottom of the second quartile for the 5-years (*Morningstar* data, NY Times, April 10, 2011).

The **High Yield Strategy (HY)** trailed the Barclays High Yield Index during Q1 (3.18% vs. 3.88%) and for the 12-months and longer periods. Our underperformance has been attributable to the performance of CCC securities within the Index. During calendar 2009, that credit subsector, accounting for more than 20% of the Index, was up more than 90% (we do not purchase securities rated below B-/B3). We ranked in the bottom quartile of High Yield Bond Funds for the quarter and the year, but we were in the top half of the second for the 5-year period (*Morningstar*).

The **Broad Market Strategy** (our corporate core plus strategy that blends the IG and HY Strategies), trailed the weighted benchmark for the quarter (1.59% vs. 1.88%), outperformed the benchmark for the twelve months, and trailed the benchmark for the 3-,5-and 10-year periods. The superior performance of CCC rated bonds during 2009 resulted in our longer-term trailing of the weighted benchmark. With respect to General Bond Funds, It ranked at the top of the first quartile for the quarter, the year and the five years. (*Morningstar*).

The **Short Duration Strategy** (our short maturity corporate core plus strategy) trailed the Barclays Weighted Intermediate benchmark for the 3-months (1.85% vs. 2.29) and the 12-month and longer periods as the high yield component of the **Strategy** lagged its benchmark (see above). Relative to General Bond Funds, the **Strategy** ranked in the top of the top quartile for the three months, 12-months and 5-years (*Morningstar*).

Our Strategies are most appreciated in and near economic slowdowns when corporate profits decline and investors' credit quality concerns mount. Our superior relative risk adjusted returns are most suited for the conservative investor.

Barclays Bond Indexes Returns vs CAM		
Periods ended 3/31/11	10 yrs	20 yrs
US Aggregate	5.56%	6.76%
US Corporate	6.21%	7.31%
CAM Investment Grade Strategy	6.16%	7.69%

**Better Asset Allocation Might Result from
More Exacting Analysis**

The chart to the right shows that high yield bonds, with the exception of the lowest rated (CC & D rated bonds), have outperformed both the Barclays US Aggregate Index and S&P 500 stocks. The highest rated bonds in the universe (BB) significantly outperformed the Aggregate and the S&P 500. However, the lowest rated bonds have also significantly underperformed all other classes of high yield.

The chart also indicates that CCC rated securities have slightly outperformed the BB and B rated bonds for the 5- and 10-years. However, the volatility of that subsector has been pronounced. For example, during 2008, when the high yield index was down 26%, CCC rated bonds were down 44%; and during 2009, the index was up 58% while CCC bonds were up 91%. So the longer term results were achieved with significant volatility relative to the index.

Finally, not only have the BB and B rated bonds outperformed the S&P 500, but they have done so with about half the volatility of that Index (Ibbotson), suggesting that better credit quality high yield bonds deserve consideration as a core holding in an investor's portfolio allocation.

Performance of High-Yield Bonds by Credit Quality
(periods ended 3/31/2011) Source: Credit Suisse First Boston

High-Yield Bond Sectors	5-years	10-years	20-years
BB-rated bonds	8.84%	8.76%	9.73%
B-rated bonds	6.53%	8.20%	9.52%
CCC-rated bonds	8.77%	10.13%	8.91%
CC & D-rated bonds	-0.85%	2.57%	-3.32%

Performance of Other Asset Classes
(periods ending 3/31/2011) Source: Barclays & Ibbotson

S & P 500 Stocks	2.53%	3.24%	8.48%
Barclays U.S. Aggregate	6.02%	5.56%	6.76%

Yield Spreads over U.S. Treasuries - relative value remains attractive since spreads remain above average. Also an abnormally steep yield curve makes intermediate maturities more attractive for yield & roll.

Yield spreads tightened toward average over the course of 2009 and 2010. But, given the low level of Treasury rates, the relative premium of corporates and high yield bonds remain attractive. The steep yield curve, low inflation expectations and problematic economic trends could result in good relative returns.

Credit Rating	1986-1Q2011 average spread*	3/31/11	12/31/10	12/31/09	High Yield at 5/31/07, Tightest this decade
A	1.18%	1.34%	1.51%	1.56%	N/A
BBB	1.87%	1.73%	1.91%	2.12%	N/A
BB	3.49%	3.37%	3.97%	4.54%	1.76%
B	7.48%	4.41%	4.92%	7.64%	2.48%
CCC	12.95%	6.86%	7.66%	10.01%	4.75%

(continued from page 1)

standing municipal debt has grown from \$360 Billion in 1981 to nearly \$2.9 Trillion in 2010 (Source: Federal Reserve & Bloomberg). Add to that state and local pensions underfunded by \$2 Trillion (Barrons 3/15/10). Add to that unfunded retiree healthcare benefits some estimate at over \$1.5 Trillion (source: Heritage Foundation). The deficits of cities and counties are yet another factor. So there is a severe debt & spending problem at the state & local level. Reduced spending will slow GDP.

Since \$1 Trillion of the \$2.2 Trillion cost of state & local government is for employee wages & benefits, salary and staff cuts are one root cause of the problem and a part of the solution. Also, many studies show wages & benefits well above those of even union workers in the private sector. The reaction to budget initiatives to modestly lower wages and benefits would lead one to believe that unions represent a significant proportion of the U.S. work force. But, state & local workers that are members of unions total just 5.34% of U.S. workers in 2010 (source: U.S. Bureau of Labor Statistics). So, most middle class workers are in the private sector. More taxes on them will be a drag on GDP growth and additional taxes on businesses will impede job growth.

Downsizing government will initially slow job growth. But the down sizing appears warranted given budget realities and from the perspective of years of government expansion. Today, there are nearly twice as many government workers (22.5 Million) as manufacturing

workers (11.5 Million). One example of government expansion is K-12 education, which accounts for about 30% of many states' spending. Between 1970 & 2005 public school employment per student has doubled. This while student achievement scores haven't improved (Univ of Washington Study cited in WSJ 4/11/11).

The key is the political will to achieve truly fair adjustments to government staffing levels (size and job descriptions are impacted by collective bargaining's work rules), wages and retirement benefits. The more significant the adjustments, the more beneficial to long term GDP trends. Simply, public and private sectors compete for limited resources. Private sector multipliers (e.g. jobs created from \$1 of profit) are much larger than those of the public sector (that some estimate at less than one, meaning government spending actually shrinks GDP because it is profits rather than taxes that stimulate jobs).

Employment is #2. The private sector jobs are key. They both employ and generate taxes; they aren't consumers of government spending. Payroll employment, which declined by 7.3 million in the recession, has increased just 70,000 (0.06%) between 6/2009 and 12/2010. Compare this to past recoveries where employment rose 4.4% on average in first 18-months. Also, underemployment for 9 million part time workers wanting full-time work is indicative of current poor conditions (CBO 1/2011). The one positive here is a lack of wage driven inflationary pressure.

Housing is #3. The S&P Case-Shiller housing price index recently fell back to 140, just a point above its 2008 low. January's 3.1% decline over a year ago following expiration of federal housing subsidies add considerable weight to Robert Shiller's prediction of "substantial risk of prices falling another 15%, 20% or 25%" (Fortune Magazine 4/5/11). The index at 140 remains 40% above its 2000 year level. Since then the U.S. private sector has created almost no net new jobs and incomes have been flat (IBID). An Oppenheimer analyst also contends overvaluation noting that "the cumulative gap between baseline inflation and home price inflation is still 25%, therefore home prices will trend flat to down for a number of years (IBID). So construction industry activity will be weak. Also, a homeowner's perception of his wealth is impacted by the value of his home. The richer he feels, the more he spends. This will help keep inflation lower, but also stifle growth.

Commodity prices is #4. Price increases are also impacting economic growth. Now, groceries & gas require 22% of worker wages. The 2-previous rises to this level lead to recessions (David Rosenberg of Gluskin Sheff). Oil, corn, cotton and many other basic commodities have risen dramatically. Global demand is driving many prices as 3rd world wealth creation drives up demand for everything from oil to high-rise apartments. The persistence of these higher prices will increase inflation. This prospect is the logic for maintaining a more conservative intermediate (5-10 years) maturity bond portfolio.

Some prices have also been influenced by government
Continued on Page 4

Footnotes and disclosure

Cincinnati Asset Management, Inc., ("CAM") an independent privately held corporation established in 1989, is registered with the United States Securities and Exchange Commission as an investment advisor. The CAM High Yield, Investment Grade and Short Duration composites consist of all discretionary portfolios under management, including all securities and cash held in the portfolios, and has been appropriately weighted for the size of the account. All accounts are included after they are substantially invested.

The Investment Grade performance prior to January 1, 1993 represents Mr. Hale's investment management performance while managing his previous employer's insurance company's fully invested "higher grade" fixed income portfolio adjusted to net the highest CAM management fee of 25 basis points per annum from the total returns.

Returns are calculated monthly in U.S. dollars and include reinvestment of dividends and interest. Past performance is no guarantee of future results.

When compared to mutual funds' performance, CAM results are after deduction of all transaction costs and CAM advisory fees. CAM advisory fees used is the composite average. Accounts managed through brokerage firm programs usually will include additional fees. "Net of fees" herein refers only to CAM's management fee. Returns audited annually. Most recent audit available upon request.

Mutual fund averages and S&P 500, as published quarterly in Barron's as supplied by Lipper Analytics.

The indices and information shown for comparative purposes are based on or derived from information generally available to the public from sources believed to be reliable. No representation is made to its accuracy or completeness.

High yield bonds may not be suitable investments for all individuals. Before investing a thorough reading of all materials and consultation with an independent third party financial consultant may be appropriate.

This material was not intended or written to be used, and it cannot be used, by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws.

This information is intended solely to report on investment strategies and opportunities identified by Cincinnati Asset Management. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This material is not intended as an offer or solicitation to buy, hold or sell of any financial instrument. References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

Fixed Income securities may be sensitive to changes in prevailing interest rates. When rates rise the value generally declines. For example, a bond's price drops as interest rates rise. For a depository institution, there is also risk that spread income will suffer because of a change in interest rates. The Indexes are referred to for informational purposes only and the composition of the Index is different from the composition of the accounts included in the performance shown above. Index returns do not reflect the deduction of fees, trading costs or other expenses.

CAM Broad Market Strategy .77
Barclays Weighted (2/3 Corporate and 1/3 High Yield) .69

CAM Investment Grade Strategy .73
Barclays U.S. Corp Index .66

CAM High Yield Strategy .53
Barclays High Yield Bond Index .44

CAM Short Duration .44
Barclays Weighted (1/2 Intermediate HY & 1/2 Intermediate US Corp) .33

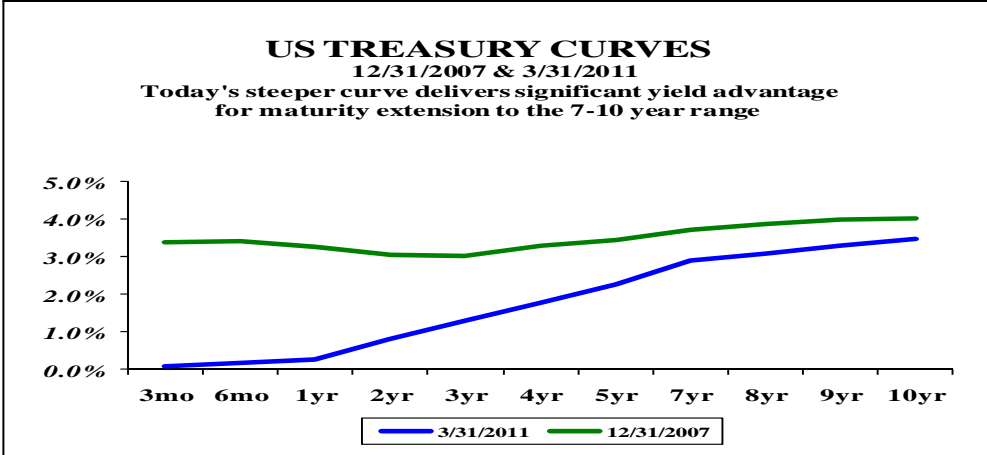
(continued from page 3)

ment policies. Corn ethanol is one example. Subsidies of Billions to divert corn to the manufacture of ethanol added to gasoline from food production has created artificial and uneconomic demand. Economist Ed Yardeni comments, "so our ethanol policy is exacerbating the global food fight" (AFP news agency 4/10/11).

The true "pork barrel" nature of the subsidies is revealed by the fact that the U.S imposes tariffs on Brazilian sugar cane ethanol, which is much more efficient than corn. Persistence of senseless subsidies is indicative of government's lack of sincerity of concern and initiative to seriously address budget & debt problems. You have to raise my taxes to pay corn farmers?

Another example is oil. Even vast on-shore reserves are deemed off limits by Government, while Cuba has contracted with international majors to drill 45 miles from Key West. So the result is larger trade deficits (impacts value of the dollar) and higher oil prices. So, its inflationary and restrains creation of many higher paying jobs.

One measure of our conservative philosophy is the Sharpe Ratio (from Firm inception 4/89 through 3/11) that measures total return per unit of risk assumed. This relative return measure is as important as, if not more important than, absolute return comparisons. Our constant objective is to deliver a good return with much less risk. These relative values measure the performance of our strategies against the benchmarks for Investment Grade, High Yield, Broad Market (corporate core plus), and Short Duration Strategies. The Broad Market Strategy has produced a return 12% greater than the Index, while the Investment Grade and High Yield Strategies have produced returns 11% and 24% greater than their respective benchmarks. The Short Duration Strategy has exceeded its benchmark by 37%.



Growth in Government regulations is #5. Regulations constrain economic activity. Some help, but many don't. For example, debit card swipe fees and many Dodd-Frank bill rules will limit credit availability. Sarbanes-Oxley rules caused many firms to remain private, reducing growth by discouraging equity capital investments. Unintended consequences? Most alarming is the EPA's CO₂ regulations that will double electric rates (AEP Corp. estimate) and regulate everything from power plants to lawn mowers. By deeming CO₂ hazardous & the cause of global warming many contend the EPA usurped congressional authority (it rejected cap and trade legislation), and is extending it's activities well beyond its legal mandates. Scientific consensus is lacking on the causes of global warming. Natural oscillation of the sun and earth's weather patterns is a serious alternate thesis to CO₂. Businesses will adapt, to electric costs and new emission rules probably by relocating or expanding elsewhere. So this will lower job growth and business expansion.

The European Debt Crisis is #6. It will continue to grow for years. The debt is a result of socio-economic policies which continue to generate debt & constrain economic growth. As in the U.S. current policies are unsustainable and demand conservative strategies to shelter one's assets.

Rating	BB	B	CCC	CC/C
Avg Spread	349	748	1,295	2,579
Std. Dev.	99	158	669	1,250
3/31/2011	337	441	686	2,297
Lowest Spread	175	248	398	1,213

Spreads to Treasuries by Credit Rating

shows significantly lower risk of BB and B rated bonds. Source: CSFB

