

# Third Quarter 2011 Bond Market Review and Outlook



## Current Events & Important Factors

### Rational Expectations

#### Outlook : Executive Summary:

Risk aversion erupted, roiling most markets in the second quarter. Heightened investor awareness and media attention rather than any substantive change in macro-economic trends drove markets down. European debt, U.S. debt, Chinese bank quality skepticism, increased probability of a recession in 2012, instability in the Middle East, & persistent high unemployment were the major issues. Disagreement between democrats and republicans over the debt ceiling was labeled by the media as a major cause. But they have been at each other's throats for the last 100 years or more.

From the end of the second quarter, investment grade corporate yield spreads increased 73% and high yield spreads increased 63%. high yield prices fell about 6%, investment grade corporates prices rose about 3% while U.S. Treasuries rallied almost 6.5%. In this typical flight to quality the S&P 500 fell about 14%. Note the lower beta of high yield bonds than equities.

Through the first days of October (today is the 14th) the high yield market has rallied about 1.5% and investment grade corporates are up about 1/2%. Markets are still well off the higher levels of this summer. High yield index yields of about 9% and +700 basis points spreads to Treasuries represent good relative value. Investment grade corporate yields of about 4% and +270 basis points spreads to Treasuries are also attractive.

#### More Detail on Macro Economic Analysis

On Monday, October 10th the Nobel Prize in economics was awarded to Thomas Sargent of NYU and Christopher Simms of Princeton. Robert Lucas of University of Chicago preceded them with his seminal work and Nobel Prize in 1995. Their work in the role people's expectations play in economic decision making and the larger economy was emphasized. One notable idea is that people's expectations about government fiscal and monetary policy make it difficult for government officials to affect the economy in ways to which they intend. So transitory policies have little impact, because people are looking further into the future to make today's investment and capital decisions.

This is at odds with the Keynesian model which has dominated Washington policies since 2008 and is a keystone of the Obama administration. It dominated economic thinking from the 1930s to the early 1970s when this and other alternate theories, such as supply side economics developed.

Rational expectations is logical and compelling in its simplicity: my feelings about tomorrow drive today's decisions to prepare me best to survive and thrive, tomorrow. (continues on page 3)

- IMF expansion considered to help Europe's debt problem means the U.S. will provide even more bail out \$\$...and this time to Europe. (Bloomberg 10/14/11)

- No labor market progress: broad gauge of unemployment (U6) is 16.5% in Sept. up from 16.2% August. (DOL)

- How will White House potential scandals wear on the economy? 1. Solyndra's (backed by democratic fund raiser George Kaiser) default on \$500 million government guarantee. 2. Attorney General Eric Holder's possible perjury in testimony before Congress over the *Fast & Furious* program.

- June CBO analysis concludes \$15 trillion in cuts + taxes over 10-years just to maintain debt:GDP ratio. This is much higher than the failed "grand bargain" of \$4 trillion.

- Baaken North Dakota oil fields could lead to energy independence and many new jobs. Administration's response; 6-Oil COs charged by DOJ under migratory bird act for death of a few sparrows, while wind energy turbines slice & dice 1,000s a year! Shell Oil questions ability to operate profitably in U.S. given regulations & legal system. So is job creation the #1 priority?

#### Yields to Maturity \* on 9/30/11

YTM

**CAM Broad Market (corporate core plus) Strategy** (8.0 year maturity; 5.9 duration) **5.11%**

**CAM Investment Grade (100% corporate bonds) Strategy** (7.7 yr maturity; 6.2 dur) **3.68%**

**CAM High-Yield Strategy (only BB & B rated purchased)** (8.6 year mat; 5.0 dur) **8.20%**

**CAM Short Duration Strategy** (4.6 year maturity; 3.5 duration, 50% IG & 50% HY) **5.36%**

**Tax Equivalent Muni GO Bond** (7 yr. = 1.97%. Barclays Institutional Index.) To right shows after 40% tax equivalency & 3-point retail price mark-up for small buys under \$1 M) **3.44%**

**U.S. Treasury\*\*** (10 year maturity) **1.93%**

**U.S. Treasury\*\*** (5 year maturity) **0.97%**

**3 Month Treasury Bill\*\*** **0.02%**

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

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### 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.

	3Q '11	1-YEAR	3-YEARS	10-YEARS
<b>CAM Broad Market Strategy</b> 1/3 high yield, 2/3 Investment grade	1.08%	3.30%	11.24%	6.01%
<b>CAM High Yield "Upper Tier" Strategy</b> only purchase BB & B no purchases of CCC & lower	-3.69%	1.50%	10.47%	6.44%
Lipper High Yield Mutual Funds Average	-6.63%	0.83%	9.88%	6.87%
<b>CAM Investment Grade Strategy</b> 100% corporate bonds	3.59%	4.25%	11.70%	5.95%
Lipper A-rated Bond Funds Average	2.84%	4.49%	9.10%	5.14%
<b>CAM Short Duration Strategy</b> 1/2 investment grade, 1/2 high yield 6/2004* start	-1.19%	1.78%	8.27%	<u>7 years*</u> 5.11%

performance, but individual security selection accounted for the balance of our outperforming the Index. Our 12-month outperformance was due principally to security selection. We trailed the High Yield Index for the 3-year and longer periods as the CCC subsector, accounting for more than 20% of the Index, was up more than 90% during 2009. We ranked at the top of the top quartile of High Yield Bond Funds for the quarter, in the middle of the top quartile for the year and for the 5-year period (*Morningstar*). The **Broad Market Strategy** (our corporate core plus strategy that blends the IG and HY Strategies), led the weighted benchmark for the quarter (1.18% vs. -0.05%), equaled the benchmark for the twelve months, and slightly trailed or approximated 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 in the top quartile for the quarter and in the second quartile for the year and the five years. (*Morningstar*). The **Short Duration Strategy** (our short maturity corporate core plus strategy) exceeded the Barclays Weighted Intermediate benchmark for the 3-months (-1.11% vs. -3.04%) and for the year (2.12% vs. 1.81%) while trailing the benchmark for 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 bottom quartile for the three months, at the top of the first quartile for 12-months, and in the middle of the second quartile for 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.

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, 2010. 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 9/30/11**

Our **Investment Grade Corporate Strategy (IG)** outperformed the Barclays Corporate Index for the 3-months (3.65% vs. 2.86%) and for the twelve months (4.53% vs. 4.41%). We approximated that Index for the 3-year period (10.95% vs. 12.59%) as Baa rated bonds significantly outperformed the Index during 2009 (we are always underweighted that credit subsector); we slightly trailed or approximated the Index for the 5- and 10-year periods. Our 3 month performance relative to the Index was negatively impacted by the superior performance of longer maturity bonds in the Index (these outperformed our portfolio by almost 90 basis points. However, our underweighting of BBB rated securities (we typically hold 20-25% of our portfolio in this credit quality versus 40% for the Index) resulted in an advantage of 6 basis points to our portfolio as BBB rated issues underperformed the Index as a whole. In addition, our consistent underweighting of Bank & Finance credits (approximately 22% of our portfolio versus 35% for the Index) contributed 36 basis points of positive performance versus the Index as those credits underperformed the

Index as a whole. The balance of our performance difference was attributable to security selection, which comprise less than 10% of our portfolio. Our 12-month superior performance was impacted by the same factors, although the differences were less pronounced. The **IG Strategy** ranked at the top of the first quartile of the General Bond Intermediate Term peer group for the 3-months, at the top of the second quartile for the year, and in the middle of the second quartile for the 5-years (*Morningstar* data, NY Times, October 9, 2011). The **High Yield Strategy (HY)** outperformed the Barclays High Yield Index during Q3 (-3.59% vs. -6.06%) and for the 12-months (1.92% vs. 1.79%). Our superior performance was attributable to the performance of CCC securities within the Index, which returned -11.73%. We do not buy CCC rated securities and benefitted by almost 1.00% versus the Index as a result. Our lack of building materials, gaming, home construction and insurance sectors in our portfolio advantaged us by 42 basis points in performance; our higher weighting in food and beverage and in healthcare provided a positive 25 basis points in return versus the Index; other over/under weightings resulted in no difference in our

Barclays Bond Indexes Returns vs CAM		
Periods ended 9/30/11	10 yrs	20 yrs
<b>US Aggregate</b>	5.66%	6.71%
<b>US Corporate</b>	6.25%	7.17%
<b>CAM Investment Grade Strategy</b>	6.20%	7.52%

**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 S&P 500 stocks and the Barclays US Aggregate Index for the 10- and 20-year periods. The highest rated bonds in the universe (BB) significantly outperformed the S&P 500 for all periods and the Aggregate except for the 20-year period. The lowest rated bonds have underperformed the higher rated high yield bonds.

The chart also indicates that CCC rated securities trailed the BB and B rated bonds for the 5-years while slightly exceeding those bonds for the 10- and 20-year periods. 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 9/30/2011) Source: Credit Suisse First Boston

High-Yield Bond Sectors	5-years	10-years	20-years
<b>BB-rated bonds</b>	8.02%	8.74%	9.16%
<b>B-rated bonds</b>	4.94%	8.41%	8.52%
<b>CCC-rated bonds</b>	4.26%	9.00%	6.64%
<b>CC &amp; D-rated bonds</b>	-2.94%	3.11%	-4.97%

**Performance of Other Asset Classes**  
(periods ending 9/30/2011) Source: Barclays & Ibbotson

<b>S &amp; P 500 Stocks</b>	-1.27%	2.77%	7.45%
<b>Barclays U.S. Aggregate</b>	6.52%	5.66%	6.71%

**Yield Spreads Over U.S. Treasuries:** relative value is attractive since spreads remain above average. Also, an unusually steep yield curve enhances the risk/reward trade off of maturity extension to the 10-year area.

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	1986-3Q2011 average spread*	9/30/11	12/31/10	12/31/09	High Yield at 5/31/07, Tightest this decade
A	1.18%	2.24%	1.51%	1.56%	N/A
BBB	1.87%	2.79%	1.91%	2.12%	N/A
BB	3.49%	5.85%	3.97%	4.54%	1.76%
B	7.48%	7.52%	4.92%	7.64%	2.48%
CCC	12.95%	11.35%	7.66%	10.01%	4.75%

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Peoples' reactions to their expectations are amorphous, so can't be measured. But what can be enumerated are policies that are in effect and those that will take effect over the next few years.

Government does have the ability to create permanent private sector jobs. But not in the manner usually attempted: through jobs programs and spending on infrastructure and subsidies to develop new industries. These are transitory and will last as long as the government funding.

Government creates private sector jobs through the policies, regulations, laws and taxes it places on the factors of production: capital, labor and materials. It can create an environment where businesses can flourish or one where they suffocate. People gauge the profit potential of any endeavor through their analysis of the environment created by government.

So what is the platform or foundation that government has built upon which businesses can flourish and create the many jobs across the full spectrum of skill and intelligence levels that will employ many people? The major elements of that "industrial base" are government created fiscal and monetary policies, taxes, regulations, and laws.

Fiscal & Monetary Policies: The government has a spending problem that has generated too much debt. For every dollar the Federal Government spends we have to

borrow about 44¢. Looking at the Federal Government's finances as if it were a family budget (remove 8-zeros from federal statistics):

- Annual income \$21,700
- Expenditures \$38,200
- New debt this year \$16,500
- Outstanding debt total \$146,750
- Total budget cuts \$385

Would you lend a dime to a household with this financial picture? While there are many differences between the Feds and a household, you still have to control spending. The private sector may be slowly deleveraging, but the Feds, continue to increase borrowing. So the S&P downgrade of U.S. debt seems justified.

Another interesting situation is that Fannie and Freddie (still working even though in "conservatorship" or bankrupt ) and the FHA currently back 9 in 10-new mortgages. And, the FHA still allows borrowers to make a down payment of just 3.5%. This seems to continue the same policies that drove them into bankruptcy. So, their \$140 Billion government bail out will grow. Given their sorry performance, the policies that failed miserably should be reversed rather than continued. This is clearly throwing good money after bad. This is especially glaring in the context of the health of the housing market. Case/Shiller estimates 2 million foreclosures to date and another 4 million coming.

Taxes: Some are arguing for higher taxes. But tax rates must be competitive or individuals and businesses will relocate or not risk additional capital on business expansion that yields profits below a level commensurate with the risk assumed

A 2008 study by The Organization for Economic Cooperation and Development (OECD) concluded that the top earning 10% of U.S workers paid the largest percent of their income among 24 countries examined (included Canada, UK, France, Germany & Japan) (source: *WSJ* 5/3/11).

U.S. Corporate income tax rates are among the highest among OECD countries a CBO 2005 study concluded. A university of Calgary study in 2011 by Chen and Mintz concluded that the U.S combined state and federal income tax rate at 39.2% is higher than all other countries except Japan at 39.5%. The OECD (largely the developed economies of the world) average corporate tax rate is 18.6% and the 83-nation average is 17.7%. Loopholes and exemptions do lower the effective rate for large corporations. But the bulk of the tax burden fall upon small businesses and lower effective rates don't impact the marginal rate (39.2%) for additional income earned.

With these tax rates, will the U.S. attract manufacturers and other businesses?

Regulations: A 2010 study out of Lafayette University by Nicole and Mark Crain for the SBA concludes that the annual costs of federal regula-

(Continues 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 .79  
Barclays Weighted (2/3 Corporate and 1/3 High Yield) .70

CAM Investment Grade Strategy .77  
Barclays U.S. Corp Index .70

CAM High Yield Strategy .50  
Barclays High Yield Bond Index .41

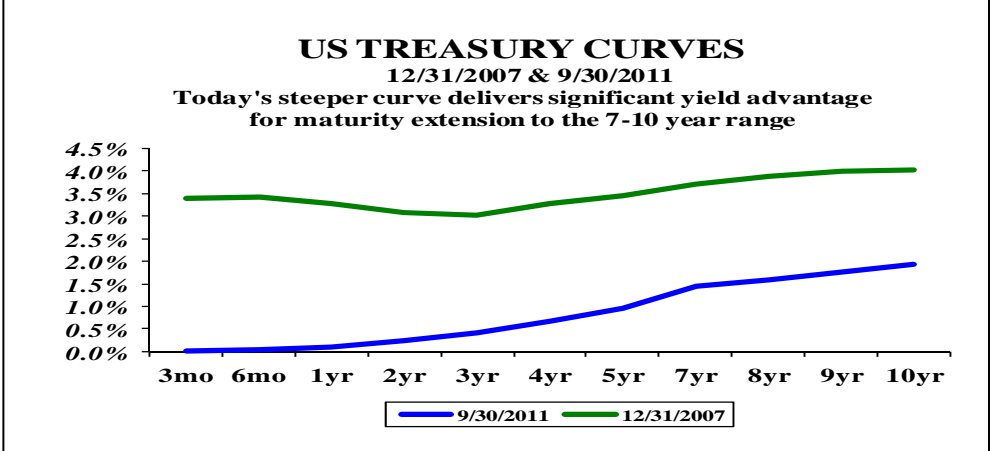
CAM Short Duration .42  
Barclays (1/2 Int HY & 1/2 Int US Corp) .25  
\*Inception 4/2004

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tion at \$1.75 trillion as of 2008. That's \$15,000 per household and compares to \$10,500 spent on healthcare. It equals 14% of national income and when combined with the 21% of income of federal tax receipts, these two costs consumed 35% of national income. Some recent cases follow:

The EPA does not subject its rules to any cost/benefit analysis. So the growth of regulatory requirements or burdens has few restraints. Until a more balanced process is developed, businesses can't plan for the future unrestrained unknowns and increased costs of doing business. Most logical plan may be avoiding U.S. located facilities.

One EPA example is the *Cross State Air Pollution Rule* requiring coal fired utilities in 27 states to slash emissions in just 2-years. This proposal along with the EPA's proposed "Utility MCAT" rule are crippling. Some estimates peg electric cost increases at 23%, the net loss of 1.4 million jobs through 2020 and compromising electricity reliability and availability due to the closure of many coal-fired plants without enough time to build replacements.

One measure of our conservative philosophy is the Sharpe Ratio (from Firm inception 4/1989 through 9/2011) 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 11% greater than the Index, while the Investment Grade and High Yield Strategies have produced returns 10% and 20% greater than their respective benchmarks. The Short Duration Strategy has exceeded its benchmark by 39%.



The National Labor relations Board (NLRB) is the federal agency under White House oversight which oversees unions and creates labor union regulations over businesses. The NLRB recently filed a lawsuit against Boeing Aircraft for expanding production by building an additional facility in South Carolina. S. Carolina is a "right to work" state. Workers have the legal freedom of choice to join a union and to pay union dues. Boeing's older facility is in Washington state. Which denies workers those freedoms, requiring union membership in unionized businesses. Boeing cited

reasons of cost competitiveness and regaining a reputation among customers for reliable...deliveries..." (source: WSJ 9/26/11).

Global Considerations

Europe continues to deteriorate. Their burdensome debt, government spending that consumes over 50% of GDP and onerous labor & environmental laws guarantee sovereign defaults.

China's banks stocks have fallen sharply on loan quality concerns.

So adjust for low growth, at best. This is no recipe for aggregate demand growth, the key.

Rating	BB	B	CCC
Avg Spread	349	748	1,295
Std. Dev.	99	158	669
9/30/2011	585	752	1,135
Lowest Spread	175	248	398

Spreads to Treasuries by Credit Rating

shows significantly lower risk of BB and B rated

