

**2010 Year End
Bond Market Review
and 2011 Outlook**



**Current Events &
Important Factors**

Economic “Crosscurrents”: Treading Water or Swept Away?

2010 was a banner year for bonds, especially corporate bonds. Of particular note, our investment grade portfolio bested most competitors. Bond market liquidity and investor demand surged against a backdrop of a plethora of economic uncertainties and widely known unsustainable serious and large structural elements in the US and many western industrialized nations.

Many forecasts estimate moderate upward revisions to GDP growth to about 3% in light of recent tax legislation. Many feel this rate is not enough to cause higher inflation. Aggregate demand growth is just not that strong here in the US and Western European Nations. Also holding down any wage/price spiral is the unemployment rate, predicted to remain above 9%. Bernanke stated that the rate won't fall as fast as they would like with GDP growth at 3% to 4%.

Along with capacity utilization rates at 76% (December, reported 1/14), consumer confidence dropping to 72.7 versus an anticipated gain (January survey U of MI, reported 1/14), CPI +1.5% year over year (December, reported 1/14) the inflation outlook is subdued. Include the anticipated continuation of high home foreclosures in 2011 and the outlook is good for bonds: modest growth and low inflation caused by lack of aggregate demand and overcapacity of at least two of the factors of production, labor and capital (the third is materials, which includes energy).

Since the world is vastly more interconnected, the health of the US economy is impacted by that of other countries. Europe is in the beginning of a decade long forced deleveraging which will restrain inflationary trends through lower aggregate demand growth. Western European governments are suffering from massive financial failures the result of gross indebtedness brought on by years of 1. over-lending to real estate speculators and over-spending by governments on social welfare programs. Similar to the U.S. the future liabilities for “promised” benefits from government retirement schemes (such as social security, here), government sponsored healthcare and unemployment “insurance” (at rates of unemployment driven higher by onerous business/industry regulation & restrictions) are structurally unsustainable. Simply, countries’ private sector businesses aren’t making enough money for their governments to collect enough taxes at a rate that maintains a competitive cost structure to pay for all these promises. Greece is effectively impoverished with the state accounting for 40% of GDP. Ireland has been ruined by its banks’ real estate lending. Portugal is weakening given its vanishing industrial base (textiles). Spain has severe real estate woes and unemployment +20% (as of October 2010 Eurostat). And the “healthier” ones, like Germany rely on their neighbors for their export driven economy. So problems will develop as a result of countries’ inability to borrow more to spend more.

The High Yield bond market witnessed unprecedented demand as new issuance of \$262 Billion (Wells Fargo 1/7/11) overwhelmed 2009’s record breaking \$154 Billion.

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- “When Americans learn they can vote themselves money the republic is finished.” attributed to Ben Franklin.
- The E.U. debt crisis is growing, stifling European GDP due to necessary deleveraging. The EU bailout has ballooned to \$1 Trillion in recent 2011 reports.
- Healthcare act viability in question as HHS grants hundreds of coverage waivers to many friends (e.g.Unions).
- AIG paid back the US Government in full on Friday 1/14/11.
- The UAW crows of a “limitless” fund to organize foreign car manufacturing plants in the U.S., but hasn’t offered to return the \$10 Billion the government gave their VEBA trust in the GM Bankruptcy in 2009.
- The largest 15 states by GDP spent over 220% of their tax receipts over the past decade. No wonder my property taxes went up!?! Projected 2011 state deficits are near \$200 billion for the 2nd year.
- Our colleague, David Karpa, CFA, was invited to serve on the Standard Sitting Committee for the CFA Institute, which determines the passing requirements for the CFA exam.

Yields to Maturity * on 12/31/10	YTM
CAM Broad Market (corporate core plus) Strategy (7.7 year maturity; 5.8 duration)	5.08%
CAM Investment Grade (100% corporate bonds) Strategy (7.7 yr maturity; 6.2 dur)	4.06%
CAM High-Yield Strategy (only BB & B rated purchased) (7.6 year mat; 4.5 dur)	7.06%
CAM Short Duration Strategy (4.4 year maturity; 2.9 duration, 50% IG & 50% HY)	4.79%
Tax Equivalent Muni GO Bond ** (7 yr. = 2.75%. Barclays Institutional Index.) To right shows after 40% tax equivalency & 3-point retail price mark-up for small buys under \$1 M)	3.92%
U.S. Treasury** (10 year maturity)	3.29%
U.S. Treasury ** (5 year maturity)	2.00%
3 Month Treasury Bill**	0.13%

* 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.	4Q '10	1-YEAR	3-YEARS	10-YEARS
CAM Broad Market Strategy 1/3 high yield, 2/3 Investment grade	-1.06%	10.65%	7.01%	6.52%
CAM High Yield "Upper Tier" Strategy only purchase BB & B no purchases of CCC & lower	1.98%	12.94%	7.50%	7.31%
Lipper High Yield Mutual Funds Average	3.55%	14.24%	7.03%	6.78%
CAM Investment Grade Strategy 100% corporate bonds	-2.52%	9.79%	6.70%	6.28%
Lipper A-rated Bond Funds Average	-1.21%	7.79%	5.64%	5.32%
CAM Short Duration Strategy 1/2 investment grade, 1/2 high yield 6/2004* start	0.05%	7.78%	5.33%	<u>5 years*</u> 5.49%

The **Broad Market Strategy** (our corporate core plus strategy that blends the IG and HY Strategies), trailed the weighted benchmark for the quarter, outperformed the benchmark for the year, and slightly trailed the benchmark for the 3-,5-and 10-year periods. It ranked in the second quartile for the quarter, and in the top of the first quartile of General Bond Funds for the 12 months and 5-years (*Morningstar*).

The **Short Duration Strategy** (our short maturity corporate core plus strategy) trailed the Barclays Weighted Intermediate benchmark for the 3-months (0.13% vs. 1.35%) 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.

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 12/31/10

Our **Investment Grade Corporate Strategy (IG)** trailed the Barclays Corporate Index for the 3-months (-2.46% vs. -1.61%) but outperformed the Index by 107 basis points for the year. We outperformed that Index for the 3-,5-, and 10-year periods. Our 3 month performance was impacted by the strong performance of shorter maturities in the Index as well as the BBB securities in the Index (we consistently underweight that credit subsector). Our superior performance for all other periods was, conversely, attributable to our underweighting the BBB sector as well as our maintaining a 6-8 year average maturity range. The **IG Strategy** includes only corporate bonds and resulted in our being in the bottom quartile of the General Bond Intermediate

Term peer group (*Morningstar* data, NY Times, Jan. 9, 2011) for the 3-months, the upper half of the top quartile for the year, and in the second quartile for the 5-years.

The **High Yield Strategy (HY)** trailed the Barclays High Yield Index during Q4 (2.11% vs. 3.22%) 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 top quartile for the 5-year period (*Morningstar*).

Barclays Bond Indexes Returns vs CAM		
Periods ended 12/31/10	10 yrs	20 yrs
US Aggregate	5.83%	6.89%
US Corporate	6.57%	7.49%
CAM Investment Grade Strategy	6.53%	7.92%

**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.

Although the chart indicates that CCC rated securities have slightly outperformed the BB and B rated bonds, 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 12/31/2010) Source: Credit Suisse First Boston

High-Yield Bond Sectors	5-years	10-years	20-years
BB-rated bonds	8.53%	9.03%	10.04%
B-rated bonds	6.37%	8.32%	10.26%
CCC-rated bonds	8.77%	9.59%	10.44%
CC & D-rated bonds	1.44%	2.15%	-2.07%

Performance of Other Asset Classes

(periods ending 12/31/2010) Source: Barclays & Ibbotson

S & P 500 Stocks	2.29%	1.41%	8.93%
Barclays U.S. Aggregate	5.80%	5.83%	6.89%

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	1986-4Q2010 average spread*	12/31/10	12/31/09	12/31/08	High Yield at 5/31/07, Tighest this decade
A	1.18%	1.51%	1.56%	4.67%	N/A
BBB	1.87%	1.91%	2.12%	6.73%	N/A
BB	3.49%	3.97%	4.54%	10.93%	1.76%
B	7.48%	4.92%	7.64%	16.59%	2.48%
CCC	12.95%	7.66%	10.01%	32.79%	4.75%

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Most investors saw returns of +12%. The default rate will continue to decline in 2011, according to recent forecasts by the three major rating agencies.

The Investment Grade Corporate market also performed well. Demand was strong with new issuance of \$910 Billion, just short of 2009's record issuance of \$917 Billion. Fully 34% was issuance by financial companies showing investor confidence. Conversely, of the worst performing +\$1 Billion issuers the top two were The State of Illinois and The City of Chicago due to credit concerns. The entire municipal bond sector was the worst performer of the investment grade universe due to credit concerns.

Looking ahead, to 2011 what are the economic trends, political and legislative actions and socio-economic forces influencing the health and wealth of the nation and world?

1.The average time unemployed rose to 34.2 weeks, near the record high also set since the recession "ended" in June 2009 (IBD 1/10/11). Unemployment just rose again to 445,000 for the first week of 2011.

2.With the "end" of the oil drilling moratorium by the administration in October they have issued zero permits to drill as of today 1/13/11 (WSJ 1/13/11). The recent report released on the BP Macondo blow out offered no evidence to justify labeling the spill as proof of "industry wide systemic failure". We are talking about a handful of guys on one rig. Oil

traded at \$91+, today (Bloomberg). Meanwhile the British Parliament rejected a drilling moratorium on the grounds it would cause "expertise to migrate" decrease "security of supply" and harm the British economy. Also Cuba has contracted with international majors to drill in deep waters about 45 miles from Key West, FL. The US geological service raised Alaska oil reserves to 50 billion barrels (compares well to Saudi Arabia's 262 billion. Ironically BP inked a deal with the Rosneft to explore the Russian Arctic. The administration choices impact jobs, the trade deficit (dollar value) and oil prices.

3.The new year greets Americans with 31,000 new regulatory laws at the state level, including a ban on the 100-watt incandescent light bulb.

4.The EPA headed by Lisa Jackson has decided to regulate carbon dioxide against the will of Congress (in the 111th Democratic-controlled congress the "Cap & Trade" bill died just last year). More regulatory arrogance?

5.Just today 1/14/11 the Administration's EPA revoked a water permit issued in 2007 for Arch Coal's Spruce Mine in W. VA. This is the first time the EPA has withdrawn a water permit for a mining project that had previously been issued. Other businesses in other industries worry about their projects. Permit revocation results in abandoned investments and job losses (250 for Arch). Does this encourage businesses to invest in job creating projects in the USA?

6.Wells Fargo, the nation's largest mortgage lender requests US regulators establish a

30% down payment on mortgages to fall outside the Dodd-Frank bill's 5% retention rule. For loans with a lower down payment, so subject to the retention rules, JP Morgan estimates interest rates to homeowners 3 percentage points higher. Others contend that the rules will drive more business to the Federal Housing Administration, which is exempt from the retention rules and guarantees loans with down payments of 3.5% (WSJ 1/13/11).

7."We have created a wall of regulatory obstacles-environmental, historical sites, etc.-that blocks doing any major project on a predictable or reasonable schedule. Not even all the kings men with all the people's money can build tunnels, railroads, wind turbines, nuclear plants or anything else significant without years or even decades of delay. If permitting were speedy, we wouldn't need government money to have a construction boom" (Tom Evslim, Vermont former recovery officer responsible for coordinating state's use of federal stimulus money WSJ 12/27/10).

8.Since 2000 over 50% of capital investment in the U.S. has been in the telecommunications industry largely related to expansion of use of the internet. Now the Federal Communication Commission (FCC) voted to enforce "net neutrality" through regulatory fiat. This after Congress (democrat controlled) declined to give the commission authority over the Internet and a ruling by a DC federal court pointing out exactly that. Is this another example of regulatory overreach? Will this encourage further aggressive investment in the telco sector?

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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 .76
Barclays Weighted (2/3 Corporate and 1/3 High Yield) .68

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

CAM High Yield Strategy .52
Barclays High Yield Bond Index .42

CAM Short Duration .41
Barclays Weighted (1/2 Intermediate HY & 1/2 Intermediate US Corp) .30

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9. The EU's "bailout" package (formally, The European Financial Stability Facility for Ireland, Greece, Portugal and others that develop problems has grown from €130 Billion to €440 billion, today. Talks continue on a fund in excess of \$1 trillion (€750 billion). The viability of the Euro currency is now regularly questioned. Otmar Issing, German economist recently warned that the "seemingly unstoppable movement toward financial transfers from the euro zone's strongest to its weakest members threatens the euro" (WSJ 1/12/11). The IMF is involved to the tune of possibly 20% and the US funds at least 20% (source: IMF). So why are we paying for Europe's bailout? Will they be able to buy more U.S. exports?

10. RealtyTrac reported (1/13/11) home foreclosures were up 2% in 2010 to 2.8 million properties an increase of 23% over 2008. The annual trends remain bleak: 2.23% of all housing units received at least one notice in 2010 (a ratio of 1:45), up from 2.21% in 2009, 1.84% in 2008, 1.03% in 2007 and 0.58% in 2006. RealtyTrac is forecasting a 20% rise in foreclosures in 2011 driving

home prices lower. This is a sad inevitability since there are over 5 million loans that are seriously delinquent but not yet in foreclosure. Lower home prices influence consumer's perceptions of their wealth and, in turn spending.

11. Is the dollar at risk of losing its status as the primary reserve & trading currency? China surpassed the U.S.A. in 2010 becoming the world's largest economy at \$14.8 trillion versus U.S.A.'s 14.6 trillion based on purchasing power parity (PPP calculates GDP using exchange rates to adjust for price differences of the same goods). China's growth has averaged 10.3% per year over the past decade, more than 6 times the U.S.A.'s (Economic Times 1/14/11).

12. Illinois just increased personal taxes 67% and corporate taxes 30%. The legislature lauded a 10% spending cap increase limit as "historic". Absent is significant spending discipline. This does nothing to correct the huge unsustainable structural budget problems of Illinois, which many states mirror. The primary problems are state union employee pension & healthcare obligations and state Medicare expenses. These are the sources of the growth in the debt. Just pensions and healthcare are underfunded by over \$2 trillion.

So economies remain weak, countries have to delever and aggregate demand is tepid. This is a good environment for bonds.

